THE ADMINISTRATION'S PROPOSAL FOR FEDERAL LOAN ASSET SALES AND CREDIT PROGRAMS

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

WASHINGTON, DC, MARCH 10 AND 12, 1987

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THE ADMINISTRATION'S PROPOSAL FOR FEDERAL LOAN ASSET SALES AND CREDIT PROGRAMS

TUESDAY, MARCH 10, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 9:10 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Present: Chairman LaFalce; Representatives Sisisky, Hayes, DeFazio, Ireland, Hiler, McMillan, and Gallegly.

Chairman LAFALCE. The House Small Business Committee will come to order. Today will be the first of 2 days of full committee hearings on the administration's budget proposals for Federal loan asset sales and credit programs.

This morning's hearing will review both the objectives and procedure for the administration's proposals for these initiatives. These hearings will examine the loan asset sale issue not only for what it means to the future of the SBA and its loan programs, but also for what it means for loan assets held by a number of other Federal departments and agencies.

The committee's direct interest in the asset sales issue is considerable. The administration is proposing to expand loan asset sales to a level of $11 billion in fiscal year 1988. A major part of this total would be in sales of approximately $3 billion in SBA loan assets. But because of its no recourse sales policy, the administration is forecasting a return to the taxpayers of less than one-third face value.

In any event, I am generally opposed to the idea of selling off assets to pay for current consumption, and I am specifically opposed to the Reagan administration's position that would apparently lead to the sale of certain taxpayer assets at prices that could be as low as 15 cents on the dollar.

The hearings have several objectives. One, to hear the House and Senate Budget Committees' views on the President's proposals for Federal Government loan asset sales and budget treatment and deficit reduction considerations involved in such sales.

Two, to be informed by administration witnesses about the administration's experiences with loan asset sales thus far, and the objectives and recommended procedures for future sales including the new credit reform initiative.

Three, to receive GAO and OMB analysis of present asset sales programs and to have them air their differences as to the best methodology for such sales.

Four, to be instructed by CBO as to current credit reform initiatives and as to the proper accounting for budgetary purposes of loan asset sales.

Five, to hear the opinions of the financial and investment banking community which will have to advise on, and participate in, the marketing of these Government assets.

Six, to hear the SEC's analysis of the legal implications of loan asset sales. And finally, to hear from SBA as to their upcoming participation in loan asset sales programs and credit reform initiatives.

Under the administration's nonrecourse sale proposal for fiscal year 1988, the Government would sell $11 billion in loans to the highest bidder who would then collect the remaining principal and interest on the loan. The administration estimates that on average it may only get one-half of the face value of these loans.

This is because the loans would be sold without recourse. That is, they would no longer be guaranteed against default by the Government. This condition makes the loan substantially less valuable on the private market and dramatically reduces the yield to the taxpayer on any sale. While selling Government loans would raise funds for the Government in the short term, there would likely be a large revenue loss in later years.

The administration's proposal calls for $277 million in deficit reduction from sale of SBA disaster loans in fiscal year 1987. Reaching this target, however, may require the sale of $800 million in disaster loans.

Similarly, the fiscal year 1988 budget proposes sales of existing SBA loan assets sufficient to generate $643 million. This would require the estimated sale of $740 million in disaster loans; $1 billion in business loans; and $500 million from development company loans.

In other words, in order to raise $643 million, the administration is prepared to sell $2.24 billion from SBA's loan portfolios. I am concerned that this program makes little economic sense, because holding these loan assets to term would typically result in substantially greater yields; 93 percent on disaster loans, and 80 percent on SBA originated direct loans.

In the course of these hearings, the committee expects to learn a great deal. But one thing should be clear from the beginning. There should be no fire sale of SBA loan assets. No hasty or unsuccessful loan asset sale should disrupt current agency programs, future loan asset sales or existing sales in the primary or secondary market for other agency financial assets upon which the 7(a), SBIC and Development Company Programs depend.

We had asked Senator Chiles, chairman of the Senate Budget Committee, to be with us this morning. He cannot do so, but he sends us a statement to share his thoughts on the subject of these hearings.

PREPARED STATEMENT OF HON. LAWTON CHILES, A SENATOR FROM THE STATE OF FLORIDA

I am pleased to provide the House Small Business Committee with a summary of the Senate Budget Committee's Hearings and views regarding the selling of existing loans, as well as the President's credit reform proposals. I have attached to my statement a copy of the Committee's views concerning loan sales and credit reform as expressed in the report accompanying the Senate Budget Committee's FY1988 spending plan. In addition, I have attached copies of summaries of the transcripts from two Budget Committee hearings this year on the Administration's credit reform recommendations and the concept of selling exiting loans to reduce the deficit. I hope these documents will be useful to you.

The President's budget this year has proposed to continue selling Federal loans to achieve deficit reduction. In addition, the President has recommended changing the scorekeeping for Federal credit activities. I would like to address credit reform first because I believe there are some positive aspects of that proposal. However, one of its greatest weaknesses is that it would allow existing loan sales to continue to be scored as deficit reduction.

The Administration's credit reform proposals, in my opinion, deserve credit themselves. I see in these proposals a serious attempt to give a more accurate picture of what it costs the government to borrow and loan money. For the most part, I believe these changes would be helpful.

As things stand now, the way credit transactions are accounted for -- or scored -- there's little relation to the actual cost to the government over the long haul.

In some ways, we treat a loan the way we treat a grant. A $100 million loan shows up as a $100 million expense. Even though the government expects to get something back on the money it loans, our current accounting practices don't reflect that.

And there's another problem. Many government loans flow through a revolving fund. When a loan is made, we offset it by other amounts coming into the fund from other transactions. It makes the cost of the loan look lower than it really is.

Whenever the government makes a loan, there's a subsidy involved -- whether it's because of lower interest rates or longer terms of repayment. The Administration's proposals want to pin down that subsidy and show it on the books as a cost to government in the first year. That's fine.

But there are several remaining questions.

The Office of Management and Budget describes the proper cost of these loans as the "benefit to the borrower." That's the difference between what a person would have to pay for a loan on the open market and what it costs to get the same amount through the government.

Where my question comes in is should the government be charged a cost unique to the private market. The private markets have higher costs, pay taxes, and, of course, seek a profit. So I wonder if those additional costs are really things we could take into account when billing the government.

I also have some questions about the issue of re-insurance. Among the proposals is to go to the private markets and ask them to reinsure many of these government loans. I'm frankly worried about programs like FHA.

FHA's been out there for decades with a solid reputation backed by the full force of the government. If we turn around and have the private lenders re-insure FHA mortgages, I wonder what sort of message that will send to the banks, to the builders, and the market in general. So I'd like more information on the re-insurance plans.

Generally speaking, I'm encouraged by the initiatives I've seen on credit reform -- with one glaring exception. Just a few weeks ago, Martin Feldstein told the Senate Budget Committee--

unequivocally -- that asset sales do not reduce the federal deficit.

So I must ask why -- with these other serious reform proposals -- the Administration is keeping up the pretense that the sale of existing loans reduce the federal deficit?

While the sale of financial assets lowers outlays in the years in which they're sold, the deficits down the road are increased by at least as much as the loan sales receipts.

Loan sales don't do anything for genuine deficit reduction. They don't reduce the structural deficit at all. In fact, asset sales are exactly the kind of budget gymnastics that will leave us flat on our faces later.

I want to take these credit reform proposals seriously. So I'm a little disappointed when I look down the list and see one of the proposals dressed up in a clown suit. Asset sales are a joke when it comes to deficit reduction.

Members of the Committee, let me say once again I'm pleased to see the Administration making an effort to give us a clear picture of our credit costs. I'm encouraged. I want to explore this further and hope we will have an opportunity to do so in the coming months.

Thank you.

EXCERPTS FROM SENATE BUDGET COMMITTEE'S FY1988 BUDGET RESOLUTION

Administration's Credit Reform Proposal

The President proposes to alter the treatment of direct loans by substituting subsidy value for the current period cash flows. Subsidy value is defined as the difference between the face value of a loan and the price the loan would have cost in the private market without government assistance. For most programs, that subsidy value or benefit-to-borrower estimate will be achieved by selling new direct loans within 90 days after they are disbursed. The purpose of the new accounting practice is to enable the budget to more adequately reflect the true long-term costs of credit assistance by the Federal government.

For loan guarantees, the net present value of the future costs of these commitments will be estimated by purchasing private reinsurance. If adopted, loan guarantees would no longer appear to be a "no cost" form of Federal assistance, but would reflect the future expected costs due to partial or total default.

President's Loan Sales Proposals

For 1988, the Administration's deficit reduction plans include the sale of $11.2 billion in loans for net receipts of $5.5 billion on average, these loans are estimated to bring an average of 61 cents on the dollar for gross receipts of $6.9 billion. An additional $1.4 billion is lost in foregone principal and interest payments so that net receipts yield only roughly 49 percent of the face value of loans sold.

Although the sale of financial assets has the effect of lowering outlays in the year in which the loan sales are consummated, the outyear deficits are increased by at least as much as the loan sale receipts. In fact, by 1991, foregone interest and principal payments will equal $3.7 billion, more than offsetting the $3.1 billion of deficit reduction loan sales scheduled for that year. Over the four years, 1988 through 1991, foregone receipts will total more than $10.8 billion.

Senate Budget Committee Recommendation

The Committee recognizes the need to improve the budgetary treatment of Federal credit assistance. The Committee has reviewed the President's credit reform proposals and concurs with its findings that measuring the costs of direct loans and loan guarantees on the basis of subsidy costs would provide a more accurate account of the government's credit activities. The committee did not conclude, however, the most appropriate measure

of credit subsidy to apply to credit programs i.e., cost to government or benefit to borrower. Under the cost to government approach, subsidy is defined as the difference between the interest costs charged the borrower and the government's interest costs (plus expected default charges and administrative expenses). The benefit to borrower approach is measured as the difference between the face value of a loan and the additional payments the borrower would have to have paid if the loan had been obtained in the private market without government assistance.

Although the Committee does not recommend the selling of any loans in this year's Budget Resolution, the Committee distinguishes between the selling of new loans in the context of credit reform and the selling of existing loans for deficit reduction. The Committee feel it would be inappropriate to sell new loans as a means to identify subsidy values before a conclusion has been reached respecting the appropriate measure of subsidy costs of credit activities.

The Committee rejects the President's recommendations to sell new loans for deficit reduction. The committee finds that selling existing loans does not reduce the deficit since loan sales merely accelerate future principal and interest repayments to the present. The committee further finds that loan asset sales neither reduce demands of the government in the credit markets nor do they increase the national savings rate. Finally, loan sales do not reduce the government's basic credit needs.

The Committee recommends that loan guarantee programs be scored on the basis of their costs to government. However, the Committee rejects the Administration's proposal to purchase reinsurance for guaranteed lending. The Committee finds that in order to effectively implement the reinsurance proposal, authorizing legislation for certain credit programs would have to be modified and therefore the changes necessary for implementation would extend beyond accounting reform.

Chairman LAFALCE. Do any other members have opening statements? Mr. Ireland.

Mr. IRELAND. Thank you, Mr. Chairman. I just want to say that you have gotten us off on the right start with the panel that we are hearing today. I think that you are quite correct. This is important not only for this committee, but also how this type of funding affects other committees in the budget. Thank you very much.

Chairman LAFALCE. Thank you. If there are no further comments by members of the committee, we will turn to our panel. Our first witness this morning will be our colleague, the Honorable Chester Atkins from the great State of Massachusetts, who appears not only in his individual capacity, but this morning on behalf of the House Budget Committee.

It is my understanding, Chet, that you have some severe time constraints and might have to leave after your remarks. If you could remain with us, we would love to have you. But if you have to leave though, of course, we would understand that. Please proceed.

TESTIMONY OF HON. CHESTER G. ATKINS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. ATKINS. Thank you very much, Mr. Chairman. You have a copy of my written statement, and I will summarize it and focus on a few points.

Chairman LAFALCE. Without objection, we will put Representative Atkin's entire statement in the record. It is so ordered.

Mr. ATKINS. Mr. Chairman, the first thing that is clear about the program of loan asset sales, currently being considered, is that it is a policy being driven almost entirely by the need for deficit reduction. The fiscal policy and economic effects of asset sales are minimal. The economic purpose of deficit reduction, which is to assist in capital formation and reduce the trade deficit by raising national savings, is simply not affected in any way by the asset sales irrespective of what that may do to help us reach so-called Gramm-Rudman target figures.

Asset sales draw funds out of capital markets precisely in the same way that Treasury borrowing does. They do not raise national savings rates in any way, shape or form.

Moreover, asset sales are a less efficient way to finance Government than Treasury borrowing. Because investors require a discount to purchase loan assets that they know little about, they are less liquid than Treasury securities.

In short, it costs the Government more to raise money with loan asset sales than with Treasury securities. Indeed, analysts have estimated, on the conservative side I believe, that we add 50 to 75 basis points to the cost of our borrowings by borrowing through loan asset sales rather than directly through Treasury securities.

With respect to programmatic considerations of the loan asset sales, I think that we would all agree that improved credit management and the explicit identification of loan subsidies are worthwhile goals. But I also think that it is fair to suggest that reforms such as these can be better accomplished without the actual sale of loan assets.

I also think that asset sales can in some instances damage the programs that they support. Loan programs represent policy decisions, for example, to enable families in rural areas to buy homes, for disadvantaged entrepreneurs to gain credit, businesses to win overseas export sales, and students to finance higher education.

These loans were made with terms and conditions that could not be obtained through private credit markets. By privatizing these loans through their sale, we could be, in effect, undercutting our original public policy goals.

Again, it may be better to be forthright about what programs we want and are willing to pay for rather than dismantling them through the back door of asset sales to private investors, who may or may not agree with the social and economic objectives of the programs.

I might point out that one of the things that I think is perhaps the most pernicious aspect of asset sales is that they take advantage of a real glitch in the Gramm-Rudman scorekeeping methodology. And because, under Gramm-Rudman, we are almost totally

driven by what CBO will do for scorekeeping, there are certain anomalies that exist.

One of the key ones is the fact that if you sincerely intend to sell an asset, and if you attempt to sell that asset and fail, you can go back in the following year and get credit once again for selling the asset. So in terms of reaching deficit reduction targets, without having to go through the pain of reducing the deficit, loan asset sales are the absolute perfect mechanism.

You may recall that we have sold Conrail three separate times, gaining full credit each time for the value of Conrail. There is an unlimited number of times that we can sell our loan asset portfolios. Right now, to my knowledge, last year they have not sold, under that program, one single dollar of loan assets.

There are numerous additional problems that have occurred in the sale of those assets, and those loan asset sales and the delay may be the elixir that avoids the pain of deficit reduction for this Congress. If we are not careful, people can reach out and sell last year's loan assets once again.

The thing that is even worse about the Conrail sale is that we not only get credit for selling the asset, but when the asset actually does not get sold, we are also able to take as offsets to the budget, any revenue that we incur from the asset portfolios over that period of time in which we did not sell them.

This points out to me a situation under Gramm-Rudman which is absolutely absurd. I do not think that it was the intention of anybody to have this kind of system. I hesitate to call it smoke and mirrors, because it is really smoke and mirrors without the trouble of having the smoke or the trouble of polishing the mirrors.

The other issue in asset sales is the overall problem of credit, and how we account for credit in the budget. I think that those who have proposed loan asset sales raise legitimate questions in terms of the credit side of the budget.

And certainly, we do have problems where all of our loans are presently accounted for on a cash basis, which really makes it more difficult for us to get a true picture of what the real deficit is, and for us to make rational planning decisions in the budget process.

There are proposals to account for new loans on a subsidy basis. Both OMB and CBO have suggested that. I think that it is the general consensus of the Budget Committee that that is a proposal which merits serious consideration, and may, in fact, be a long overdue reform to the budget process.

However, the OMB and the CBO calculation of old loans are quite different. Under the OMB proposal, old loans would still be accounted for on a cash basis. That leads us to what I believe is a serious inconsistency where you have it both ways. You get the benefits of accounting for new loans on a subsidy basis and you get the illusory deficit reduction potential of accounting for your old loans on a cash basis.

And, if we, in fact, are to reform our credit system, I think that it would be clear that we ought to do it consistently and account for new loans and old loans in the same fashion.

There is also the question as to how we measure the subsidy cost of Federal loans. I think that to measure that subsidy cost in terms

of the private sector valuation would in fact place an extra cost on the Government. And what we ought to do is to look at that subsidy cost based simply on the extra costs to the Government of making those loans rather than in the private returns to individuals.

I think that it is very clear that loan asset sales should not be seen as a way to resolve our fundamental deficit problem. They have no economic impact in terms of the deficit problem.

Those sales can, potentially, in some instances, accelerate collections under present accounting practices, and that should be looked at, but they do nothing to change the structural imbalance between outlays and receipts. And any decisions that this Congress makes or this committee makes on loan asset sales, I would hope would be based on the programmatic and economic merits of that policy rather than the potential to deceive the public with illusory deficit reduction. Thank you very much.

[Mr. Atkins' prepared statement follows:]

Prepared Statement of Hon. Chester G. Atkins, a Representative in Congress From the State of Florida

INTRODUCTION

I AM DELIGHTED TO BE HERE THIS MORNING TO DISCUSS SOME OF THE KEY ISSUES SURROUNDING THE SALE OF FEDERAL LOAN ASSETS. CHAIRMAN GRAY, WHO IS DEEPLY INVOLVED IN BUDGET MATTERS AT THIS TIME, HAS ASKED ME, AS A MEMBER WHO IS CONCERNED ABOUT THESE ISSUES, TO REPRESENT THE HOUSE BUDGET COMMITTEE AT YOUR HEARING.

LET ME SAY AT THE OUTSET THAT I PERSONALLY DO NOT FAVOR ASSET SALES. THEY DO NOT PERMANENTLY REDUCE THE BUDGET DEFICIT. THEY ARE AN INEFFICIENT, COSTLY WAY OF FINANCING GOVERNMENT ACTIVITIES. AND, FROM A PROGRAM STANDPOINT, THEY MAY BE POOR PUBLIC POLICY. HOWEVER, IN THIS ERA OF GRAMM-RUDMAN FIXED DEFICIT TARGETS AND PRESIDENTIAL UNWILLINGNESS TO PAY FOR THE ACTIVITIES OF GOVERNMENT, THERE IS CONSIDERABLE PRESSURE TO CONSIDER ASSET SALES AS PART OF A DEFICIT REDUCTION PACKAGE.

WHAT I WOULD LIKE TO DO THIS MORNING IS TO REVIEW BRIEFLY RECENT ADMINISTRATION AND CONGRESSIONAL ACTIVITY WITH RESPECT TO LOAN ASSETS SALES AND THEN TO DISCUSS THE ECONOMIC, POLITICAL AND BUDGETARY IMPLICATIONS OF SUCH SALES. I WOULD CONCLUDE WITH SOME OBSERVATIONS ON THE RELATIVE MERITS OF THE CBO AND ADMINISTRATION PLANS TO CHANGE THE BUDGET TREATMENT OF THE FEDERAL CREDIT PROGRAMS.

RECENT DEVELOPMENTS

IN ITS BUDGET FOR FISCAL YEAR 1987 THE ADMINISTRATION PROPOSED A "PILOT PROGRAM" OF LOAN ASSET SALES FROM A NUMBER OF PORTFOLIOS TOTALING $4.4 BILLION

IN FACE VALUE. THE STATED RATIONALE WAS THAT THE PRIVATE SECTOR COULD MORE EFFICIENTLY ADMINISTER THESE LOANS AND THAT SUCH SALES WOULD REDUCE THE BUDGET DEFICIT.

CONGRESS TURNED TO LOAN ASSET SALES LAST SUMMER AFTER THE CONGRESSIONAL BUDGET OFFICE RAISED THE 1987 DEFICIT ESTIMATE BY $19 BILLION. THIS MADE THE POLICIES IN THE BUDGET RESOLUTION INSUFFICIENT TO REACH THE GRAMM-RUDMAN DEFICIT TARGET OF $144 BILLION. IT THEN BECAME CLEAR THAT THE GRAMM-RUDMAN TARGET COULD NOT BE REACHED BY FURTHER CUTS IN SPENDING OR BY INCREASES IN REVENUES INTRANSIGENTLY OPPOSED BY THE ADMINISTRATION. THUS, THE ADMINISTRATION AND CONGRESS AGREED TO THE SALE OF LOAN ASSETS WHICH WOULD REDUCE THE DEFICIT BY AN ESTIMATED $4.8 BILLION IN 1987. I SHOULD NOTE HERE, PARENTHETICALLY, THAT NONE OF THESE 1987 SALES HAVE BEEN ACCOMPLISHED YET. FARMERS' HOME ADMINISTRATION IS THE FURTHEST ALONG, RECENTLY NAMING ITS UNDERWRITERS FOR THE SALE OF RURAL DEVELOPMENT LOANS.

THE ADMINISTRATION'S 1988 BUDGET PROPOSES TO SELL AN ADDITIONAL $11.2 BILLION IN LOAN ASSETS AT FACE VALUE WHICH WOULD PRODUCE OFFSETTING RECEIPTS OF $5.3 BILLION. AFTER ADJUSTING FOR LOAN REPAYMENTS THAT WOULD HAVE OCCURRED IF THESE ASSETS HAD NOT BEEN SOLD, THESE LOAN ASSET SALES WOULD RESULT IN ESTIMATED NET DEFICIT REDUCTION OF $4.2 BILLION.

AS WE APPROACH THIS YEAR'S BUDGET DISCUSSIONS, THERE SEEMS TO BE A GROWING REALIZATION ABOUT THE SHORTCOMINGS OF ASSET SALES AS AN APPROACH TO DEFICIT REDUCTION AS WELL AS THE RECOGNITION THAT SUCH SALES MAY BE POOR PUBLIC POLICY. IT IS TO THOSE ISSUES THAT I WOULD NOW LIKE TO TURN.

ECONOMIC AND PUBLIC POLICY CONSIDERATION OF LOAN ASSET SALES

THE ADMINISTRATION AND OTHER PROPONENTS OF LOAN ASSET SALES CLAIM THAT SUCH SALES CAN IMPROVE THE GOVERNMENT'S CREDIT MANAGEMENT, YIELD ADMINISTRATIVE COST SAVINGS, AND IDENTIFY HIDDEN LOAN SUBSIDIES WHILE AT THE SAME TIME PROVIDING AN ALTERNATIVE MEANS OF REDUCING THE DEFICIT, ALBEIT TEMPORARILY.

ALTHOUGH THE SALES OF ASSETS TO THE PUBLIC MAY HAVE A PROGRAMMATIC RATIONALE, WHICH I WILL DISCUSS IN A MOMENT, THIS POLICY IS NOW BEING DRIVEN PRIMARILY BY THE NEED FOR DEFICIT REDUCTION. YET THE FISCAL POLICY AND ECONOMIC EFFECTS OF ASSET SALES ARE MINIMAL. THE ECONOMIC PURPOSE OF DEFICIT REDUCTION IS TO ASSIST CAPITAL FORMATION AND REDUCE THE TRADE DEFICIT BY RAISING NATIONAL SAVING. ASSET SALES DRAW FUNDS OUT OF CAPITAL MARKETS PRECISELY IN THE SAME WAY TREASURY BORROWING DOES. THEY DO NOT RAISE NATIONAL SAVING.

MOREOVER, SUCH SALES ARE A LESS EFFICIENT WAY TO FINANCE GOVERNMENT THAN TREASURY BORROWING BECAUSE INVESTORS REQUIRE A DISCOUNT TO PURCHASE LOAN ASSETS THAT THEY KNOW LITTLE ABOUT AND THAT ARE LESS LIQUID THAN TREASURY SECURITIES. IN SHORT, IT COSTS THE GOVERNMENT MORE TO RAISE MONEY WITH LOAN ASSET SALES THAN WITH TREASURY SECURITIES. ALSO, SUCH ASSET SALES BRING IN CASH IN THE YEAR OF SALE, BUT THIS IS OFFSET BY THE LOSS OF FUTURE RECEIPTS THAT THE ASSETS WOULD OTHERWISE GENERATE. ALL IN ALL, WE WOULD BE BETTER OFF IF WE HELD ONTO THE ASSETS AND SIMPLY BORROWED THE MONEY AT TREASURY RATES.

WITH RESPECT TO PROGRAMMATIC CONSIDERATIONS, I THINK WE ALL AGREE THAT IMPROVED CREDIT MANAGEMENT AND THE EXPLICIT IDENTIFICATION OF LOAN SUBSIDIES

ARE WORTHWHILE GOALS, BUT I ALSO THINK IT IS FAIR TO SUGGEST THAT REFORMS SUCH AS THESE CAN BE BETTER ACCOMPLISHED WITHOUT THE ACTUAL SALE OF ASSETS. INDEED, CBO'S PROPOSAL FOR REFORMING CREDIT BUDGET SCOREKEEPING, WHICH I WILL DISCUSS IN A FEW MINUTES, IS JUST SUCH AN APPROACH.

I ALSO THINK THAT ASSET SALES CAN, IN SOME INSTANCES, DAMAGE THE PROGRAMS THAT THEY SUPPORT. LOAN PROGRAMS REPRESENT POLICY DECISIONS TO, FOR EXAMPLE, ENABLE FAMILIES IN RURAL AREAS TO BUY HOMES, DISADVANTAGED ENTREPRENEURS TO GAIN CREDIT, BUSINESSES TO WIN OVERSEAS EXPORT SALES, AND STUDENTS TO FINANCE HIGHER EDUCATIONS. THESE LOANS WERE MADE WITH TERMS AND CONDITIONS THAT COULD NOT BE OBTAINED THROUGH PRIVATE CREDIT MARKETS. BY "PRIVATIZING" THESE LOANS THROUGH THEIR SALE WE COULD BE, IN EFFECT, UNDERCUTTING OUR ORIGINAL PUBLIC POLICY GOALS. AGAIN, IT MAY BE BETTER TO BE FORTHRIGHT ABOUT WHAT PROGRAMS WE WANT AND ARE WILLING TO PAY FOR RATHER THAN DISMANTLING THEM THROUGH THE BACKDOOR OF ASSET SALES TO PRIVATE INVESTORS WHO MAY OR MAY NOT AGREE WITH THE SOCIAL AND ECONOMIC OBJECTIVES OF THE PROGRAMS. THIS BRINGS ME TO MY FINAL SET OF OBSERVATIONS -- THOSE ON OMB'S AND CBO'S PROPOSALS FOR CREDIT REFORM.

CREDIT REFORM.

BECAUSE OF GROWING DISSATISFACTION WITH THE BUDGET TREATMENT OF ASSET SALES, BOTH CBO AND THE ADMINISTRATION HAVE RECENTLY PROPOSED REFORMING THE CREDIT BUDGET AND ITS ACCOUNTING. CBO HAS PROPOSED TO DO THIS BY CHANGING CREDIT BUDGET ACCOUNTING, WHILE THE ADMINISTRATION'S PLAN WOULD ATTEMPT TO ACHIEVE A SIMILAR RESULT WITHOUT A CHANGE IN ACCOUNTING RULES, BUT WITH A SYSTEM THAT IS MORE CUMBERSOME AND LESS REALISTIC.

BY WAY OF BACKGROUND, LET ME NOTE THAT EXISTING CREDIT BUDGET ACCOUNTING IS CASH-BASED, AS IS THE ENTIRE FEDERAL BUDGET. MAKING A DIRECT LOAN

INCREASES OUTLAYS AND THE DEFICIT; REPAYING OR PREPAYING A LOAN IS AN OFFSET TO OUTLAYS AND REDUCES THE DEFICIT. UNDER CASH FLOW ACCOUNTING, LOAN ASSET SALES ARE TREATED AS A FORM OF PREPAYMENT AND THUS OFFSET OUTLAYS AND REDUCE THE DEFICIT. SIMILARLY, LOAN GUARANTEES INVOLVE NO GOVERNMENT CASH DISBURSEMENTS UNLESS THERE IS A DEFAULT. CONSEQUENTLY, LOAN GUARANTEES AFFECT OUTLAYS OR THE DEFICIT ONLY WHEN DEFAULTS HAVE TO BE PAID FOR.

MANY BUDGET ANALYSTS BELIEVE THAT THE PROBLEM WITH THE EXISTING TREATMENT OF THE CREDIT BUDGET IS THAT IT CAN DISTORT THE SIZE OF THE FEDERAL DEFICIT AND GIVE A MISLEADING VIEW OF PROGRAM COSTS. THIS IS BECAUSE CASH-FLOW ACCOUNTING IS NOT WELL-SUITED TO CREDIT ACTIVITY WHICH INVOLVES THE EXCHANGE OF CASH NOW FOR PROMISES TO PAY CASH IN THE FUTURE.

FOR EXAMPLE, WHEN A LOAN IS DISBURSED TO A BORROWER, THE FULL AMOUNT IS COUNTED AS AN OUTLAY AS THOUGH THE LOAN WERE INSTEAD A GRANT. THIS ACCOUNTING OVERSTATES THE "TRUE" COST OF THE LOAN BECAUSE THE GOVERNMENT RECEIVES AN IOU WHICH PROMISES A FUTURE STREAM OF REPAYMENTS. A MORE USEFUL APPROACH TO MEASURING THE "TRUE COST" TO THE GOVERNMENT IS TO INCLUDE A GRANT-EQUIVALENT MEASURE OF THE LOAN OBLIGATION OR LOAN GUARANTEE. THIS CAN BEST BE APPROXIMATED BY THE LOAN'S SUBSIDY VALUE.

CBO HAS PROPOSED THAT CURRENT CREDIT BUDGET ACCOUNTING BE CHANGED FROM A CASH FLOW BASIS TO A SUBSIDY BASIS. AS THE CBO ANNUAL REPORT NOTES:

> "MOST ANALYSTS BELIEVE THAT A MORE APPROPRIATE MEASURE OF COST FOR DIRECT LOANS AND LOAN GUARANTEES IS THEIR SUBSIDY COST, OR THE PRESENT VALUE OF FUTURE DEFAULTS, INTEREST LOSSES, CAPITAL COSTS, AND ADMINISTRATIVE

EXPENSES... THE SUBSTITUTION OF SUBSIDY COST FOR CASH FLOWS WOULD TIGHTEN THE LINK BETWEEN THE DEFICIT AND THE ECONOMIC IMPACT OF THE BUDGET. IT WOULD ALSO IMMUNIZE THE DEFICIT FROM THE EFFECTS OF LOAN SALES, REFINANCING EXISTING LOANS, AND SUBSTITUTING LOAN GUARANTEES FOR EQUAL-SUBSIDY DIRECT LOANS."

THIS APPROACH IS NOT NEW. THE PRESIDENT'S COMMISSION ON BUDGET CONCEPTS, WHICH ESTABLISHED OUR PRESENT UNIFIED BUDGET, MADE A SIMILAR RECOMMENDATION IN 1967.

THIS CBO APPROACH, IF ADOPTED FOR FISCAL YEAR 1988, WOULD REMOVE FROM THE BUDGET ALL LOAN REPAYMENTS AND PREPAYMENTS, REMOVE ALL LOAN DISBURSEMENTS, BUT ADD THE SUBSIDY COST OF ALL EXISTING AND NEW LOANS AND LOAN GUARANTEES. BECAUSE LOAN ASSET SALES ARE A FORM OF PREPAYMENT AND DO NOT AFFECT THE NET SUBSIDY OF THE LOAN PROGRAM, SUCH SALES WOULD NOT COUNT AS DEFICIT REDUCTION UNDER THE CBO APPROACH. THIS WOULD ELIMINATE THE POLITICAL INCENTIVE TO SELL LOAN ASSETS TO REDUCE THE DEFICIT AND LEAVE SUCH DECISIONS TO BE BASED ON MANAGEMENT EFFICIENCY. IT WOULD PROVIDE A FAR MORE ACCURATE PICTURE OF THE REAL BUDGET DEFICIT. I MIGHT NOTE THAT THE CBO ESTIMATE OF THE PRESIDENT'S BUDGET DEFICIT FOR 1988 OF $134 BILLION WOULD BE RAISED SIGNIFICANTLY UNDER THIS MORE REALISTIC ACCOUNTING.

THE ADMINISTRATION'S CREDIT REFORM INITIATIVE ALSO IS AN ATTEMPT TO ACHIEVE SUBSIDY-BASED SCOREKEEPING FOR THE CREDIT BUDGET, BUT THERE IS A MAJOR DIFFERENCE FROM CBO'S PROPOSAL. THEIR PROPOSAL WOULD APPLY SUBSIDY-BASED SCOREKEEPING TO <u>NEW</u> LOANS AND LOAN GUARANTEES ONLY; IT WOULD CONTINUE TO TREAT EXISTING LOANS AND GUARANTEES UNDER A CASH-BASED SYSTEM AND THUS, SALES OF

EXISTING LOANS ASSETS WOULD STILL BE TREATED AS DEFICIT REDUCTION. THE ADMINISTRATION ACHIEVES THE BEST OF BOTH WORLDS BY PROPOSING AN INCONSISTENT BUDGET -- NEW LOANS ARE ACCOUNTED ON A SUBSIDY BASIS, WHILE OLD LOANS ARE ACCOUNTED ON A CASH BASIS.

MOREOVER, I FORESEE OTHER DIFFICULTIES IN THE ADMINISTRATION'S PLAN. THEY PROPOSE TO DEFINE THE SUBSIDY COST OF LOANS BY SELLING NEW LOANS AS THEY ARE MADE AND BY REINSURING NEW LOAN GUARANTEES AS THEY ARE COMMITTED. I AM NOT AT ALL SURE THAT SELLING LOANS AND REINSURING GUARANTEES IS GOOD PROGRAMMATIC OR FINANCIAL POLICY. I ALSO QUESTION WHETHER IT IS APPROPRIATE TO MEASURE THE SUBSIDY COST OF FEDERAL LOANS IN TERMS OF THEIR PRIVATE SECTOR VALUATION. IT SEEMS TO ME THAT THE SUBSIDY COST SHOULD BE BASED ON THE EXTRA COST TO THE GOVERNMENT OF MAKING SUCH LOANS RATHER THAN THE PRIVATE RETURNS TO INDIVIDUALS. FURTHER, I FEAR THAT THE PRIVATE SECTOR WILL BE UNUSUALLY CAUTIOUS IN DEALING WITH THESE LOAN ASSETS AND REINSURANCE COSTS, AND THE GOVERNMENT WILL BE THE FINANCIAL LOSER.

IN EXAMINING THE TWO PROPOSALS, IT SEEMS TO ME THAT CHANGING CREDIT BUDGET ACCOUNTING, AS THE CBO PROPOSES, WOULD BE SUPERIOR TO THE ADMINISTRATION'S PLAN SINCE IT TREATS BOTH OLD AND NEW LOAN ASSETS ON A CONSISTENT BASIS, IS MUCH SIMPLER TO IMPLEMENT, AND PROTECTS THE GOVERNMENT'S PROGRAM AND FINANCIAL INTERESTS BY NOT REQUIRING LOAN ASSET SALES.

LET ME CLOSE BY OBSERVING THAT LOAN ASSET SALES SHOULD NOT BE SEEN AS A WAY TO RESOLVE OUR FUNDAMENTAL DEFICIT PROBLEM. WHILE SUCH SALES CAN ACCELERATE COLLECTIONS UNDER PRESENT ACCOUNTING PRACTICES, THEY DO NOTHING TO CHANGE THE STRUCTURAL IMBALANCE BETWEEN OUTLAYS AND RECEIPTS. MORE FUNDAMENTAL CHANGES ARE NEEDED TO BRING THE BUDGET INTO BETTER BALANCE AND ALLEVIATE THE ECONOMIC PROBLEMS THAT THESE LARGE DEFICITS HAVE CAUSED.

Chairman LAFALCE. Thank you very much, Chet.

Do any members of the panel have questions of Congressman Atkins?

Mr. SISISKY. Mr. Chairman, I want to congratulate Mr. Atkins on his testimony, which I think was very wise. I think he illustrated the realities of the last few years as they relate to budget deficits. I appreciate him being here this morning.

Chairman LAFALCE. Thank you.

Mr. ATKINS. Thank you.

Chairman LAFALCE. Chet, before you leave I have one question. Suppose we wanted to adopt CBO's proposal to change credit budget accounting, what would be necessary for us to do that?

Mr. ATKINS. I perhaps should turn that over to the gentleman representing CBO here. But I believe that it would be rather difficult for us to do it at this stage in the budget for this year's budget. But certainly, for future budgets, a large portion, and correct me if I am wrong, a large portion of the CBO changes could be done administratively if there was agreement on the part of the Budget Committees, CBO, and OMB. However, certain portions would require statutory changes.

Chairman LAFALCE. We will get into that with CBO a bit later. Again, thank you for your excellent presentation to help educate the members of this Small Business Committee about the intricacies of asset sales. Thank you.

Mr. ATKINS. Thank you very much. And let me thank this committee for their work on the issue in the past. This committee was the first committee that really understood, I think, asset sales for what they were, an illusion, and asked some hard questions about the programmatic effects of those asset sales.

I congratulate you for holding this hearing and look forward to reading the testimony of your various panels on this subject. Thank you.

Chairman LAFALCE. Thank you very much. Our next witness, and we will hear from all of the witnesses before we question them, will be Mr. Joseph Wright, the Deputy Director of the Office of Management and Budget.

Mr. Wright, we have an approximately 20-page statement which we will include in its entirety in the record. I would ask you to summarize your statement to the extent that you can.

TESTIMONY OF JOSEPH R. WRIGHT, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. WRIGHT. Thank you, Mr. Chairman. And by the way, welcome to the chairmanship of the Small Business Committee.

Chairman LAFALCE. Thank you.

Mr. WRIGHT. I am pleased to be here to discuss this important subject today. I would like to, as you suggested, put my testimony in the record as well as the testimony that I gave to the Senate Budget Committee last week, because it was primarily focused on the credit reform package which will be coming up later this week.

Chairman LAFALCE. Without objection, so ordered.

Mr. WRIGHT. The President's fiscal 1987 budget proposed a pilot program to sell $4.4 billion in Federal loan assets. And the fiscal

1987 Reconciliation Act increased that to $7.1 billion in loan asset sales.

Mr. Chairman, I would like to say that I was part of the design of that original proposal last year. The purpose was, as I mentioned in my testimony, to go slow, to put together a pilot program to learn what we are doing, to work with those agencies who we felt had the most to learn from a small loan asset sales program.

I stated what the objectives are in my testimony of that program. And we found ourselves in the middle of reconciliation, and you know what the pressures are at that particular time, particularly on the Gramm-Rudman Act, and we came out with a pilot that was far larger than what we had originally proposed.

The intent at the time was to put together a pilot, so that we could learn something about how you handle the subsidies within these Federal programs, how you can make them consistent for better decisionmaking by the Congress and by the executive branch, and then how you can improve the management by private sector standards of many of the Federal portfolios.

We at that time had every intention of coming in with the credit reform proposal. Because at that time, as you know, Bill Gradison of the House and Senator Trible had already proposed a market plan for 3 years in a row and Senator Heinz had proposed the appropriations plan.

So we felt that this initiative, that had really started in the Congress, had merit, and the administration was finally going to get behind credit reform because we felt that a lot had to be done.

The Pilot Sales Program was the forerunner of the credit reform proposal that will be coming up later this week. I would like to say that reducing the deficit was not one of the primary objectives of that pilot sales program. If it were, we would have taken the recommendations of GAO. We would put these sales, albeit small, on a full recourse basis with a full tax-free passthrough and a few other stipulations to get the highest amount of dollars we possibly could for the portfolios.

As such, the way that they were designed, you are absolutely correct in your statement that it increased the discount by about as much as you could increase it, because it was a credit management improvement program. It was not a deficit reduction.

Now we have been asked the question: "Would you have proposed it if you would have gotten no credit for deficit reduction?" And the answer, Mr. Chairman, is yes; we would have, because that is the way that it was designed. When it got up in reconciliation, that is the way that it got increased. If I had simply wanted deficit reduction, I would not have put it together this way.

I have heard that one of the ways of getting around this would be to take the credit for the loan asset sales or whatever it is, and apply it against the debt and not the Gramm-Rudman deficit targets. Fine. I have no problem with that. So I want to state what our intent was when we did the original design, and the way that we are following through on this.

The fiscal 1987 proposal, I would like to say for the committee, represented 1.8 percent of the total direct loans out there. That is over $250 billion. Now there is no question that you could not have

sold all of it off, nor would you want to. After it came through reconciliation, we ended up with 2.9 percent of total direct loans.

Now while I hope that I have emphasized the fact that the main intent is to improve the operations of the credit programs, I have got to make one caveat that is important. This program is not designed to terminate programs that are currently authorized or funded by the Congress, and there is nothing in the pilot program that in any way reduces the legal and contractual rights of borrowers. I think that is important to note.

I would like to say before this committee right now, that we do not have all of the answers. We feel like this is a learning process. We are willing to go ahead and work with this committee and the other committees in terms of developing this program as we go through time. This is the reason that we proposed a pilot program.

This is the reason that we asked that all agencies bring in financial advisors from the outside. And the only two that did not do so were HUD, which has got Ginnie Mae that has been in this business for many years, and the VA, which has been in this business also, although not exactly in the way we are proposing, but close to it. All of the rest of the agencies are bringing in financial advisors as the first step.

That loses us time in terms of loan asset sales if we were just reducing the deficit. It gains us time if we are improving credit management. And as we are sitting here right now, and you can go ahead and check Farmers Home or the other agencies, and you will find that the agencies are upgrading the information on their portfolios right now that, Mr. Chairman, they should have done anyway in order to properly manage their programs. So I think that you are getting some real benefits that are sometimes lost in the fray.

Mr. SISISKY. Would you repeat that, please?

Mr. WRIGHT. Yes, sir; the agencies, in order to prepare some of their portfolios, even though it is a small portion of their portfolios, for sale, are, even now, upgrading the management information that they have got within their files and within their central system, but they should have been doing this anyway just to manage internally.

Mr. SISISKY. Just to manage it.

Mr. WRIGHT. I am saying that they should have done this all along. And there is no number of OMB circulars, or budget reviews or management reviews that we could possibly have had that would have had the same impact.

Now the specific guidelines that we did provide at the time were, first, that sales should be without future recourse, and, second, securities sold should be subject to full Federal tax. Furthermore, each agency should choose, through a competitive process, a professional financial consultant beforehand.

Another guideline is that loan asset sales may be conducted on a competitive bid or a negotiated basis, and they should be sufficiently large to attract qualified bidders that will provide a good return for them.

The reaction to the Pilot Sales Program has been very positive so far. The Farmers Home Administration recently advertised to hire

underwriters and 39 investment houses came forward. The first sale is now scheduled to take place in June.

For SBA, the fiscal 1987 budget proposed gross receipts of $277 million from the sale of the SBA disaster loans on a face value, as you mentioned, of $800 million. And the fiscal 1988 budget would produce a total of $643 million on gross receipts from the sale of about $2.2 billion, as you also mentioned on face value. That is from three different portfolios within the SBA.

I would also like to say that one of the things that we tried to do is be very conservative. Because one of the things that we do not want to do is to have to come back to the Congress, particularly the budget committees, in a future reconciliation, and say that we overestimated the amount that we thought that we would be able to get from any one of the sales.

SBA has issued a request for a proposal to hire a private sector financial consultant. I believe that was done about the third week of January. An advisor will be hired through an open competitive process. My guess is that this will happen sometime in March. And of course, the financial advisor hired cannot then bid on any of the portfolios.

The credit reform package that we will be proposing formally later this week, is a reform of the way that credit programs are treated in the budget. And it has been proposed in at least one House of the Congress in each of the past 3 years. This is the first time that the administration has come in support of those particular proposals.

Like I said, I have submitted the testimony for the record. The intent here is to eventually use the best practices of both the private sector and the Federal Government to the point where you have the Federal Government continuing to make credit policy as to where those loans would actually be disseminated and then use the private sector for collection management, which they have shown that they do better than we do.

Now the purpose also is to establish accurately and equitably the subsidies and the benefits of the Federal credit programs. While we do come up with an estimate of what the subsidies are in the budget every year, that is based upon the best analysis that we can possibly obtain from what we think it would cost the borrower to obtain in the private sector. It is not a market tested concept at all. So when the Congress is making decisions between credit programs, it does not have the best information on what the subsidy values are. And when you are making decisions on not only credit programs but comparing credit programs to grant programs, or to those that are direct expenses of Government, you do not have any comparable information.

So one of the important results, I believe, on whatever form this comes out of, credit reform will be a good information base for the Congress and the executive branch to be able to stay on top of what are the costs comparisons between the various types of Federal programs.

The agencies would obtain the appropriations equal to the subsidy component for the direct loans and the loan guarantees each year. The Congressman was correct when he says that we would

not go out for the total loan value of a direct loan when it is made. *It would be the subsidy component.*

On the other hand, on the guarantees, there would be a net cost to the Government. Because what you would do on the guarantee, which we have about $176 billion going out in fiscal 1988, you would purchase private sector insurance, reinsurance so that that guarantee never comes back into the Federal Government again. That costs money.

It is supposed to be phased in over a period of 5 years. We are not sure that there is an industry out there that is large enough to be able to pick up all of the guarantees we make, which is one of the reasons that we phase it in.

On a net basis, credit reform costs the Government money over the next 5 years, because the amount of the reinsurance premiums for guarantees exceeds the revenue from the sale of the loan asset under the direct loan process. So if this is smoke and mirrors, it is in reverse. This is a cost starting in the third year to the fifth year.

Now when you come in over a period of 10 years, yes; there is no question that we will save money, because you will not be picking up the liability of the guarantee again.

A revolving fund within the Treasury would be set up. This would be handling the principal financing of the direct loan, and it would also provide oversight for all of the agencies.

I would also just like to make one comment, and then I will stop, Mr. Chairman. As the Congressman said, why do we not handle the new loans and guarantees the same way on the credit reform as we do the old ones.

I am more than happy to discuss that, but I am not so sure exactly how it would be done. But understand that you would have $450 billion in guarantees that have already gone out from the Federal Government that you would now have to reinsure that are in various stages of currency and delinquency. I am not exactly sure how you would do that. And it would be an enormous cost in terms of the premiums.

On the direct loans, that would be one of the biggest smoke and mirrors that I have ever seen in my life. We have got $252 billion out there in direct loans. Some of these are defaulted guarantees, by the way, that are classified direct. Would we now back off of the costs that we included in the past and charge only the subsidy value? Would we give ourselves a credit for future loans that are made that are only scored when the direct loan is actually paid?

So, I am saying that I would be more than happy to discuss it, but I think that could get you into some serious problems. I would not know how to handle credit reform except saying we are going to start at this point forward.

But I want to make it very clear that we do not have all of the answers here. I would be more than happy to work with the committee. What we are doing is trying to put together a good credit management program that does not affect the decisions made by the Congress and the executive branch on loan policies and does not affect borrower rates. It is a good management program. Thank you, sir.

[Mr. Wright's prepared statement, with attachment, follows:]

PREPARED STATEMENT OF JOSEPH R. WRIGHT, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. Chairman and Members of the Committee: I am pleased to be here today to discuss the Administration's proposal to improve the management of Federal credit programs. I will also comment on the Administration's proposal to sell Federal loan assets. These proposals are important additions to the President's overall plan to improve the management of Government programs. (In FY 1986, the Federal Government made $41 billion in new direct loans and provided $159 billion in loan guarantees. At the end of FY 1986, the Federal Government held $252 billion in direct loans and $450 billion in guaranteed loans. When Government-sponsored enterprises are added, the Federal

Government controls or influences nearly $1.2 trillion in outstanding credit.) These proposals will complement the improvements that are being made in the origination, servicing, and disposition of Federal credit.

LOAN ASSET SALES

Broad Objectives

The President's FY 1987 budget proposed a pilot program to sell $4.4 billion in Federal loan assets; the FY 1987 Reconciliation Act called for $7.1 billion in loan asset sales. The FY 1988 budget proposed a sale of $11.2 billion. These sales were developed to promote efficiency in Government by focusing on four principal objectives:

- Improved credit management. Federal credit programs were designed with an emphasis on granting loans, rather than collecting and servicing loans. Therefore, the delinquency and default rates are much higher than in private sector, which is more efficient in these fields. Furthermore, the sale of loans on a regular basis is forcing agencies to improve their loan documentation (in order to satisfy the private sector's standards for information), which should help them in the daily management of their portfolios.

- **Administrative savings.** When loans are sold, Federal agencies should be able to use staff time formerly devoted to collection and servicing to improve the operation and administration of credit programs.

- **Identify subsidies.** The sale of loans on a nonrecourse basis will reveal the private market's evaluation of the true value of a Federal loan. This information will allow the Government to reflect more accurately the cost of Federal credit in the budget. Present budgeting practices do not measure accurately the cost of direct loans.

- **Reduce the deficit in the short-term.** The revenues generated by the nonrecourse sale of loans is an offsetting collection that reduces the Federal deficit in the year of sale. But the primary reason for these loan asset sales is to improve the management of credit and to combine the best efforts that both the Federal Government and private sector can bring to the efficient handling of a very large investment that the taxpayers are financing.

Use of a Pilot Program--Start Slowly

The Administration sought to accomplish the objective of reforming credit programs by beginning the limited, pilot loan asset sales proposed in the FY 1987 budget:

- The pilot program proposed in FY 1987 represented 1.8% of total direct loans that could have been put up for sale. This amount was increased to 2.9% in reconciliation.

- This pilot program format was adopted because agencies did not have the information or expertise to go on a larger scale. The pilot was designed so that the Government would avoid making errors that could be costly to the American taxpayer and avoid the sale of assets at "fire sale" prices.

- The pilot program is also a way for individual agencies to become familiar with experienced financial advisors as well as the sale of their assets in private financial markets before entering these markets on a larger scale.

- We will carefully review the outcome of the first year's sales process and may, as a result, revise some aspects of the pilot program. Indeed, this is the very purpose of a pilot program.

Loan asset sales are an effort to improve the operation of credit programs. They are not designed to terminate programs that are currently authorized and funded by the Congress. Furthermore, there is nothing in this pilot program that in any way reduces the legal and contractual rights of borrowers. When we sell the loans, the rights are passed on as part of the package on which investors will bid. Naturally, some of those rights may cause investors to bid less than they would have otherwise in order to recoup additional overhead costs.

Specific Guidelines

Each of the agencies involved in the sales program is responsible for selling its own loan assets. In order to ensure that their separate efforts achieve the goals of improving Government efficiency and serve the broader interests of the American taxpayer, the Working Group on Federal Credit Policy, a subcommittee of the Economic Policy Council, promulgated specific guidelines for the agencies to follow. I would like to discuss some of the more important of those guidelines.

1. Loan asset sales should be made without future recourse to the Federal Government.

   - If loans were sold with recourse, the basic objectives of selling loan assets would be thwarted.

- Private investors would have less incentive to pursue rigorous, but legal, collection efforts since bad loans could be turned back to the Government.

- Investors would look to the guarantee placed on the loans, and not to the credit risk underlying the loan. Consequently, investors would not be as concerned with the information supporting the loan, and agencies would not have to improve loan documentation standards.

- Agencies would still have to administer bad loans as they do currently. Existing staffs for that purpose would be maintained and agencies would not achieve any administrative savings from the sale.

- Investors would bid for the loans based on their evaluation of the guarantee, not on the underlying loan risk. As a result, the information derived from the sale would not reveal the true cost of Federal loan programs and the subsidy value of the loans would not be determined from the sale discount.

- Although the prices investors will pay for loans sold with recourse are higher than the prices for the same loans on a nonrecourse basis, the Federal Government does not actually gain any extra revenue through recourse sales. Investors pay more for recourse loans only

because they know that the Government will compensate them in case the borrower defaults. The rate of default is the same whether or not the loans are sold with recourse. In other words, the Government pays for defaults when they actually occur if the loans are sold with recourse, or in a lump sum upfront in the form of a higher discount if the loans are sold on a nonrecourse basis. Either way, the Government pays for default, and so there is no gain in total revenue by selling loans with recourse.

- If loans were sold with the full faith and credit of the United States, the sale would be similar in form to a Treasury security. As such, both OMB and CBO would consider the paper being sold as a form of borrowing, and the proceeds from the sale would not be considered offsetting collections that would reduce the deficit.

2. **Loans made to tax-exempt entities shall be sold only if the future interest payments on those loans are subject to full Federal tax. This does not preclude sale to tax-exempt investors. Exceptions may be made in the future on a case-by-case basis.**

- **Many of the loans held by Federal agencies are made to borrowers who would be considered tax-exempt if they**

borrowed in the private market.

- o The sale of tax-exempts loans would involve the loss of future tax revenues to Treasury. Although investors would pay more for a tax-exempt than a taxable loan, Treasury has evidence that indicates that the higher price received would not fully compensate the Government for the loss of taxes that it would suffer.

3. Where appropriate, each agency shall choose, through a competitive process, a professional financial consultant to provide expertise on its loan asset sale program. Consultants will not be permitted to purchase loans from programs on which they are advising.

4. Loan asset sales may be conducted on a competitive bid basis or negotiated basis. In the latter case, the invitation to negotiate should be disseminated widely, and negotiations conducted as competitively as possible.

5. Loan asset sales shall be sufficiently large to assure market interest. Details of sale shall be handled individually by each agency and will vary from portfolio to portfolio depending on market conditions.

- o The common purpose of these guidelines is to ensure that the sale of the Government loan portfolio is conducted as

efficiently as possible to guarantee the highest return possible under the conditions stated, and to ensure that the interest of the public is protected by procuring expert advice.

- Loans will be packaged for sale in a way that attracts the interest of potential investors. Agencies will be able to sell their loans in a form that makes the most sense for the type of security involved.

Reaction to the Pilot Sales Program

From the start of this initiative, the investment community has been very interested in the asset sales program. We received useful advice from many investment and commercial bankers even before the sales effort was fully underway. When the Education Department began seeking outside financial advisors, 12 major institutions made bids to win that contract. When the Farmers Home Administration (FmHA) recently advertised to hire underwriters, 39 investment houses came forward to offer their services. These experiences demonstrate the extent of the market's interest in the asset sales proposal.

Although no sales have occurred yet, we have received clear indications of interest in our portfolios from investors. The first sale is now scheduled to take place in June, when FmHA will offer the first part of a sale that will eventually yield $1.0

billion in receipts.

FmHA has gotten expert financial advice on how to structure its sales offerings in order to achieve the largest amount of proceeds possible within the guidelines we have established. When the time for sale comes, FmHA will use the services of experienced underwriters to ensure that the sales goes smoothly. We are proceeding cautiously and doing everything that we can to be certain that the interests of the taxpayers are safeguarded in this sale and every other undertaking.

The GAO Report on Loan Asset Sales

We read with great interest the GAO report of September 25, 1986, that was entitled "Loan Asset Sales: OMB Policies will Result in Program Objectives Not Being Full Achieved" (GAO/AFMD-86-79). The overriding theme of that report, repeated at several times throughout the document, is that sales without recourse will produce lower receipts to the Government than sales with recourse. Two general observations are in order:

- First, GAO misses the important point that deficit reduction is not the primary objective of the Administration's pilot loan asset sales program. If it were, we would have not only guaranteed all the loans to be sold, but also sold them on a tax-exempt basis. This would have ensured the maximum return for them in the

short run. However, the sales program focuses principally on other goals -- improving credit management, achieving administrative savings, and identifying subsidies. GAO fails to consider the long-term benefits that the Government and the taxpayer will derive from the accomplishment of these goals.

- Second, as I noted above, it is true in the short-term that Government revenues would be greater if loans were sold with recourse than if they were sold without recourse. However, total revenues over time would not be greater if loans were sold with recourse. Although the Government would receive higher revenues at the time of sale, those additional revenues would be offset in the future as the defaults on the guaranteed loans began to occur. Loan asset sales with recourse are nothing but an accounting gimmick intended to inflate current year collections at the expense of outyear outlays.

I will submit for the record more extensive remarks on the GAO report that were sent to the Congress last December.

SBA's Loan Asset Sales

I will briefly discuss the sales of SBA loan assets. I understand that an official of the Small Business Administration will testify before you in just a few days. He or she will be

able to provide a more detailed description of the agency's sales program.

The FY 1987 budget proposed gross receipts of $277 million from the sale of SBA disaster loans. The FY 1988 budget would produce a total of $643 million in gross receipts from the sale of SBA loan assets -- $254 million from disaster loans, $140 million from general business loans, and $249 million from development company loans. These sales would substantially reduce SBA's loan servicing costs and would provide information useful in estimating the subsidies provided by the various SBA credit programs.

In accordance with the Working Group guidelines, SBA has issued a request for proposal (RFP) to hire a private sector financial consultant to help the agency analyze its portfolio and prepare it for sale in the marketplace. An advisor will be hired through an open, competitive process to ensure that all interested parties have a chance to participate and that the Government gets the best possible advice at reasonable cost.

SBA is now considering various ways of achieving its FY 1987 revenue goal. They have prepared a preliminary sales proposal that the Working Group on Federal Credit Policy will discuss tomorrow in light of established guidelines. The guidelines are a flexible framework that allows the various agencies involved to develop sales plans that meet the unique needs of their

portfolios while observing principles that protect the interests of the Government and the taxpayer.

CREDIT REFORM

Your letter of invitation asked that I discuss the Administration's proposal to reform the way credit programs are treated in the budget. This is a subject on which I recently testified before the Senate Budget Committee and appears to be of great interest in the Congress since it has been proposed in at least one house in each of the past three years. We look at the pilot loan asset sales program as the first step toward the reform of Federal credit. I will summarize for you the testimony I gave before that committee and will provide the full text of that testimony for the record.

Credit reform is intended to use eventually the best practices and talents of both the Federal Government and private sector in the management of $1.2 trillion in credit programs. It would also establish the true economic cost of credit -- the present value of the subsidy -- and charge that cost to any agency making or guaranteeing loans. Adoption of this proposal would be a significant improvement over current practice. It would:

- o accurately and equitably measure the subsidies and benefits of Federal credit programs to assist decision-making in both the Administration and the Congress;

- o encourage delivery of benefits in the form most appropriate to the needs of beneficiaries;

- o put the cost of credit programs on an expenditure basis equivalent to other Federal spending; and

- o improve the allocation of resources among credit programs and between credit and other spending.

Under this reform, Federal agencies would obtain appropriations equal to the subsidy component of the direct loans and loan guarantees they make each year. As agencies make new direct loans or loan guarantees, they would pay the subsidy value of those loans into a newly created central revolving fund that would be established in the Department of the Treasury. The cash disbursement for direct loans would be recorded in the central fund; in this way, the subsidy value of a direct loan would be evaluated and recorded separately from its financing in the budget account of the originating agency. The subsidy value of a loan guarantee would be evaluated and recorded directly for the first time in the budget account of the originating agency. As a result of this process, loan guarantees would be put on a basis

comparable to direct loans.

The central fund would oversee the sale of all direct loans for which there are no policy or programmatic constraints to asset sales, and it would oversee the private sector reinsurance of guaranteed loans insofar as it is avaliable. The subsidy cost of direct loans sold and loan guarantees reinsured would be determined by the actual price established by the market. Other loan subsidies would be calculated according to procedures already established.

Because of the limited availability of reinsurance for Federal loans at present, the net savings from the sale of direct loans -- $1.8 billion -- would exceed the cost of reinsurance by an estimated $1.3 billion in 1988, reducing the deficit by this amount compared to past accounting practices. As a private industry develops to reinsure these guarantees, the amount of reinsurance purchased would grow and is expected to exceed the proceeds from loan sales by 1990.

Details of this proposal and specific legislative language are being prepared and will be sent to the Congress later this week.

AN INTEGRATED EFFORT TO IMPROVE CREDIT MANAGEMENT

As I noted at the beginning of my testimony, both the loan asset sales program and the credit reform proposal are part of a larger, integrated effort to improve the management of Federal credit programs.

The asset sales program was created primarily to improve the way Federal agencies administer their credit programs, and I believe that some benefits have already come from it even though no sales have occurred yet. For example, prior to the initiation of the Administration's pilot program for loan asset sales, documentation of loans -- the simple keeping track of who owes what and how much has been repaid -- was frequently neglected. Documentation on nearly 60% of the Department of Education's facilities loans could not be found. Similar problems existed for the loans held in the 2,000 Farmers' Home Administration offices around the country. These problems have been corrected already. The financial advisors that we have contracted with as part of the pilot program know what is required and are teaching the agencies what they need to know to assure that the sales are conducted in a professional manner designed to achieve the highest returns to the Government. By continuing this process, we will reduce the Government's cost of operating credit programs and cause agencies to upgrade their techniques of loan origination and documentation.

Credit reform can also be regarded as an adjunct to other credit management improvements. In 1981, the Reagan Administration inherited large loan programs where credit and debt collection management was nonexistant. Credit was extended to farmers, homeowners, students, small businessmen, exporters and local, State and foreign governments with little emphasis on repayment. There was no centralized policy guidance to promote effective loan servicing or foster timely collections. Federal program managers devoted their time to loan disbursement rather than the collection of debt. Agencies lacked the tools to employ acceptable debt collection practicies. Automated information and processing systems were almost nonexistent, and program managers were forced to rely on antiquated manual systems. Specific legislative authority was lacking, so agencies could not use such long-established private sector resources as private collection agencies and credit bureaus.

The Reagan Administration accepted the challenge of improving the management of the Government's unwieldy financial portfolio as soon as it assumed office. We had to start from scratch.

-- First, we developed an overall policy for Government-wide credit management and established an accurate and reliable statistical base for tracking progress and basing decisions.

-- Congress and the Administration joined in a cooperative effort to give agencies the tools they had previously lacked. The Debt Collection Act of 1982 authorized use of credit bureau reports to screen those applying for Government credit and empowered agencies to contract with private collection agencies to collect delinquent debt. In 1984, the Deficit Reduction Act authorized income tax refund offsets, and just last year the Federal Debt Recovery Act gave the Attorney General authority to contract with private attorneys to assist the Justice Department in delinquent debt litigation.

-- In August 1986, Office of Management and Budget Director Jim Miller announced a Nine-Point Credit Management Program which requires all agencies to fully implement effective credit management and debt collection programs. We have just negotiated specific performance goals for each major credit agency to assure achievement of the Nine-Point Program.

Six years of hard work have begun to pay off. Credit management has improved dramatically in many agencies and our performance goals process will assure continuing progress. However, more is needed. We have now reached the point where fundamental change is needed if we are to achieve a lasting reform of Government credit management. The incentives in the

system must be changed from encouraging just giving money away to assuring that the best loans possible are awarded to achieve most fully the statutory purposes of Federal loan programs. Loan asset sales are a major step in that direction. They force agencies to recognize the tie between awarding a loan and the price they will receive in the marketplace. They force agencies to face up to the need to assure that each and every loan is fully and properly documented.

Loan asset sales are important not only because they force agencies to remedy past problems, but because they pave the way to the future of credit reform. They do so through establishing an accurate, market-determined subsidy rate for the Government's loan programs -- a precondition for credit reform. They also place responsibility for collection of debt where it can best be handled -- in the private sector.

Our overall plan for credit can be thought of in this way: credit reform will give us better information about the credit programs that we administer, and both loan asset sales and the credit management improvement initiatives will enhance the operation of those programs. In short, these efforts are designed to make better use of the taxpayers' dollar when it comes to Federal credit.

Mr. Chairman, thank you for hearing my views on these important proposals. I hope I was able to communicate that these proposals are an attempt to substantially improve the management of our Federal credit programs -- not to simply reduce the deficit. This concludes my prepared remarks. I would now be happy to answer any questions you or the Members of the Committee may have.

PREPARED STATEMENT OF

JOSEPH R. WRIGHT

DEPUTY DIRECTOR

OFFICE OF MANAGEMENT AND BUDGET

before the

SENATE BUDGET COMMITTEE

UNITED STATES SENATE

WASHINGTON, D.C.

MARCH 4, 1987

Mr. Chairman and Members of the Committee: I am pleased to be here today to discuss the Administration's proposal to reform the way credit programs are managed in the Federal Government. This proposal is an important addition to the President's overall plan to improve the management of Government programs. (In FY 1986, the Federal Government disbursed $42 billion in new direct loans and provided $159 billion in loan guarantees. At the end of FY 1986, the Federal Government held $252 billion in direct loans and $450 billion in guaranteed loans.) The credit reform proposal will complement the improvements that are being made in the origination, servicing, and disposition of Federal credit. Most importantly, the proposal will permit the Congress and the Administration to consider credit and direct spending programs on an equal basis.

Although Congress has proposed various ways to reform Federal credit programs in the past few years, this proposal represents the Administration's first endorsement of a credit reform plan.

Let me explain the problem we now face with credit programs and how credit reform will help to solve it.

Credit in the Budget

The present budgetary treatment of Federal credit programs results in an inaccurate measure of their cost, an inappropriate guide to the allocation of resources, and an ineffective means of control. Whereas the present budget records the true cost of Federal purchases, grants and transfers, it does not do so for credit.

- For direct loans, the present budget measures net cash flow -- the new loans to borrowers (and any interest paid) minus interest received and repayments of previous loans which could have been made 20 or more years ago. This is misleading in four ways:

(1) the gross disbursement of new loans overstates their cost to the government because the government now owns a financial asset with market value which is not recorded as being of value;

(2) the fact that loans are expected to be repaid leaves the impression that, over time, they are costless, but this is not so because Federal credit programs provide subsidies to borrowers;

(3) the subtraction of repayments on previous loans confuses the effect of current decisions; and

(4) the budget accounts do not contain information on how much of the new loan is a financial asset and how much is a subsidy or expenditure.

o For loan guarantees, the present budget does not record any costs unless and until defaults occur. At the time the commitment to guarantee is made, a loan guarantee is considered a free good when compared with either a grant or a direct loan.

Because of the inadequacies of the present budgetary treatment for recording credit transactions, a separate credit budget was created to record and to place some limitation on the volume of new direct loan obligations and new guaranteed loan

commitments. The credit budget has the advantage of focusing attention on the decisions that commit the Government to new expenditures. But it does not show the size of the subsidies or expenditures; it shows the total volume of credit assisted. Thus it does not distinguish between programs with deep subsidies, like the P.L. 480 export credits program with a 95 percent subsidy, and those with smaller ones, like the Rural Electrification Administration's loans to electricity distributors with a 4.8 percent subsidy. Moreover, the credit budget is separate from the unified budget, so that tradeoffs between credit and other spending cannot be made.

Credit Reform Proposal

The inadequacies of current budgeting for credit have been recognized in two bills that the Congress considered during the past few years. Several versions of the "Market Plan" were proposed by Senator Trible and Congressman Gradison. The later versions of the bill simplified the original proposal by modifying the requirements to sell all newly issued and existing loans and to reinsure all new loan guarantees. The "Appropriations Plan" proposed by Senator Heinz would estimate the true cost of credit programs and require agencies to request appropriations for them; it would create a central revolving fund for the unsubsidized portions of direct and guaranteed loans.

The Administration's credit reform proposal builds on the ideas put forward in those two bills in order to improve the way credit is treated in the budget. The proposal would:

- measure accurately and equitably the benefits and subsidies of Federal credit programs;

- put the cost of difect loan credit programs on an expenditure basis equivalent to other Federal spending;

- recognize the cost of guaranteed loans at the time these loans are made;

- encourage delivery of benefits in the form most appropriate to the needs of beneficiaries; and

- improve the allocation of resources among credit programs and between credit and other spending.

As you can see from these objectives, the credit reform proposal has been designed as a way of addressing the current shortcomings of budget accounting for credit programs. It would change the present system of scorekeeping for credit programs and give both members of Congress and the Administration better information to evaluate the costs and benefits of Federal credit programs.

It is important at this point to dispel any misunderstandings that may exist about our proposal.

- Nothing in credit reform alters the credit programs that the Congress has enacted or changes the existing authority of agencies to operate credit programs. Agencies will continue to arrange and approve direct loans and loan guarantees in the way they do now.

- It does nothing to alter the Congress's discretion to establish the amount of loans that may be granted. What it does do is to put the budgetary resources provided to credit programs through the appropriations process on an equal footing with the budgetary resources provided to other programs.

- It does nothing to alter the existing legal or contractual rights of the borrowers.

- The proposed budgetary treatment of credit affects the deficit only to the extent that loan assets are sold and guaranteed loans are reinsured. The "scoring" of the Administration's credit reform proposal is itself deficit neutral.

- Credit reform uses loan asset sales and guaranteed loan reinsurance as a tool to help establish the true value of Federal credit programs and as a vehicle to use the private sector to manage collections. The primary purpose of the loan sales is not to reduce the deficit -- it is for good credit management. Indeed, the deficit savings achieved by loan asset sales are increasingly offset by the loss of payments of principal and interest as well as by outlays for the purchase of reinsurance for guaranteed loans. In sum, we would support credit reform with loan asset sales and guaranteed loan reinsurance even if it had no impact on the deficit at all.

Subsidies: Key to Credit Reform

A new Federal credit revolving fund would be established within the Treasury Department. In addition to funding loans and overseeing the sale of direct loans and the reinsurance of guaranteed loans, a major responsibility of the fund is estimating the subsidies for agency loans.

A large part of the ultimate success of this plan depends on the ability of the fund to establish correct subsidy values for direct loans and loan guarantees. The subsidy estimate should provide a measure of the grant-equivalent costs of the current period loan obligations and guarantee commitments. One way to

estimate that subsidy is to sell the direct loans or reinsure loan guarantees. This approach would determine the grant-equivalent costs of a direct loan by comparing the market value of the loan with its face value. The grant-equivalent costs of a loan guarantee would be measured as the cost of getting the private sector to assume the liability, i.e., the cost of reinsurance. If loans are sold or reinsured, then all aspects of the loan are taken into account -- administrative costs, cost of capital, default risks, after-tax return on investment, availability of credit, and statutory forbearance provisions.

However, it is not necessary to actually sell or reinsure all loans to estimate the grant-equivalent costs. It is possible to estimate the cost of comparable loans made in competitive markets by reviewing data that are available from private sector loan transactions. Although this approach is subject to a margin of error, it has the advantage of avoiding problems that arise in selling or reinsuring certain types of loans. Our credit reform proposal would estimate subsidies by using a mix of actual loan sales and reinsurance with estimates made by the fund using private sector loan data. For example, in FY 1988, out of $11 billion in direct loan disbursements we plan to sell $4 billion. In the same year, out of $176 billion in guaranteed loan commitments, we plan to reinsure about $8 billion at a cost of $0.5 billion.

How the Plan Would Work

I will now describe how credit transactions would occur and be measured for direct loans and guaranteed loans under the credit reform proposal.

For direct loans:

- Federal agencies would be required to obtain appropriations equal to the estimated grant-equivalent subsidy of the direct loans they make.

- An agency would continue to accept and process applications for new direct loans as it does now. As loans are disbursed to recipients, the agency would pay the fund for the subsidy represented by those disbursements. That subsidy payment would be recorded as an outlay of the originating agency. The fund itself would provide the unsubsidized balance of the loan amount through the use of its permanent indefinite budget authority.

- Direct loans would be sold to the public or be held by the fund if they were exempt from sale. If the loans were sold, the sales would be made on a nonrecourse basis and the collections from the sale would be an offsetting collection to the fund. If the loans were

held, the agency would service the loan on behalf of the fund. Principal and interest payments received by the agency would be forwarded to the fund.

- Not all direct loan programs will be included in the credit reform proposal. Those excluded are the CCC commodity loan program, which is more of a commodity purchase program than a credit program, and direct loans that result from defaulted guaranteed loans, which are more of an extension of the loan collection process than they are new loans. In addition, several programs will be included in the credit reform proposal but will be exempt from requirements to sell loan assets. For example, international loans with foreign policy ramifications and loans made by financial regulators will not be required to be sold. The actual decision about which loans to sell and which to hold should be left to the discretion of the Secretary of the Treasury or his representatives, who are the officials with ultimate responsibility for operating the fund, subject to normal Office of Management and Budget review.

For loan guarantees:

- Federal agencies would be required to obtain appropriations equal to the estimated grant-equivalent subsidy of the loan guarantees they make.

- Agencies would continue to accept and process applications for new guaranteed loans as they do now. At the same time as a guaranteed loan is issued by a lender, an agency would pay the fund for the subsidy represented by that loan. The subsidy payment would be recorded as an outlay of the originating agency. This procedure means that, for the first time, loan guarantees would require the use of budgetary resources. The agency would also transfer to the fund the fees paid by the borrower.

- Guaranteed loans could either remain a contingent liability of the fund or be reinsured with the private sector. If reinsured, the cost of reinsurance would be an outlay of the fund and the cost of any future defaults would be borne by the private reinsurer. If the loans were held by the fund, they would continue to be insured by the Government. The subsidies and fees, plus the interest thereon, would constitute a reserve; the cost of any future defaults would be borne by the fund.

- All guaranteed loans are scheduled to be reinsured, but the program will be phased-in over a 5-year period in order to allow the reinsurance industry to develop. We believe that as the insurance industry becomes more

familiar with the type of risks guaranteed by the Government, reinsurance markets will develop for the full range of Federal guarantees. In fact, we assume that nearly all federally guaranteed loans can be reinsured by 1992. In 1988, we have limited the purchase of reinsurance to a portion of the housing and student loans guaranteed by the Government. Meanwhile, the Working Group on Federal Credit Policy will be developing guidelines for reinsuring loan guarantees as well as looking into how to improve the collections process.

Functions of the Fund

As I said earlier, a Federal credit revolving fund would be created within the Treasury Department. Treasury would assume the following administrative functions in order to implement credit reform:

- Establish an automated accounting and control system to keep track of the status of the fund's lending activity and ensure that agency credit activity is limited to the amounts appropriated for subsidy costs.

- Estimate the subsidy value for loans so that the program agency can request appropriations for the subsidy amount.

- Provide oversight of loan asset sales that will be conducted by program agencies. However, Treasury would have permissive authority to make such sales itself.

- Provide oversight of insurance purchased from private insurers that will be done by program agencies. However, Treasury would have permissive authority to purchase such insurance itself.

- Hold as collateral any assets that result from the default of borrowers. Treasury would oversee the liquidation of such collateral by program agencies, although Treasury would have permissive authority to sell such assets itself.

The credit revolving fund would be separate from the Federal Financing Bank (FFB) and the FFB will be gradually phased-out as the loans it currently holds are repaid.

An Integrated Effort to Improve Credit Management

As I noted at the beginning of my testimony, the credit reform proposal is part of a larger, integrated effort to improve the management of Federal credit programs.

This committee recently heard testimony about the Administration's plans to sell existing loan assets, so I don't want to take much more of your time on that issue. But I would like to observe that the asset sales program was created primarily to improve the way Federal agencies administer their credit programs, and I believe that some benefits have already come from it even though no sales have occurred yet. For example, prior to the initiation of the Administration's pilot program for loan asset sales, documentation of loans -- the simple keeping track of who owes what and how much has been repaid -- was frequently neglected. Documentation on nearly 60% of the Department of Education's facilities loans could not be found. Similar problems existed for the loans held in the 2,000 Farmers' Home Administration offices around the country. These problems have been corrected already. The financial advisors that we have contracted with as part of the pilot program know what is required and are teaching the agencies what they need to know to assure that the sales are conducted in a professional manner designed to achieve the highest returns to the Government. By continuing this process, we will reduce the Government's cost of operating credit programs and cause agencies to upgrade their techniques of loan origination and documentation.

Credit reform can also be regarded as an adjunct to other credit management improvements. In 1981, the Reagan Administration inherited large loan programs where credit and debt collection management was nonexistant. Credit was extended

to farmers, homeowners, students, small businessmen, exporters and local, State and foreign governments with little emphasis on repayment. There was no centralized policy guidance to promote effective loan servicing or foster timely collections. Federal program managers devoted their time to loan disbursement rather than the collection of debt. Agencies lacked the tools to employ acceptable debt collection practicies. Automated information and processing systems were almost nonexistant, and program managers were forced to rely on antiquated manual systems. Specific legislative authority was lacking, so agencies could not use such long-established private sector resources as private collection agencies and credit bureaus.

The Reagan Administration accepted the challenge of improving the management of the Government's unwieldy financial portfolio as soon as it assumed office. We had to start from scratch.

-- First, we developed an overall policy for Government-wide credit management and established an accurate and reliable statistical base for tracking progress and basing decisions.

-- Congress and the Administration joined in a cooperative effort to give agencies the tools they had previously lacked. The Debt Collection Act of 1982 authorized use of credit bureau reports to screen those applying for

Government credit and empowered agencies to contract with private collection agencies to collect delinquent debt. In 1984, the Deficit Reduction Act authorized income tax refund offsets, and just last year the Federal Debt Recovery Act gave the Attorney General authority to contract with private attorneys to assist the Justice Department in delinquent debt litigation.

In August 1986, Office of Management and Budget Director Jim Miller announced a Nine-Point Credit Management Program which requires all agencies to fully implement effective credit management and debt collection programs. We have just negotiated specific performance goals for each major credit agency to assure achievement of the Nine-Point Program.

Six years of hard work have begun to pay off. Credit management has improved dramatically in many agencies and our performance goals process will assure continuing progress. However, more is needed. We have now reached the point where fundamental change is needed if we are to achieve a lasting reform of Government credit management. The incentives in the system must be changed from encouraging just giving money away to assuring that the best loans possible are awarded to achieve most fully the statutory purposes of Federal loan programs. Loan asset sales are a major step in that direction. They force agencies to recognize the tie between awarding a loan and the

price they will receive in the marketplace. They force agencies to face up to the need to assure that each and every loan is fully and properly documented.

But, loan asset sales are important not only because they force agencies to remedy past problems, but because they pave the way to the future of credit reform. They do so through establishing an accurate, marketplace-established subsidy rate for the Government's loan programs -- a precondition for credit reform. They also place responsibility for collection of debt where it can best be handled -- in the private sector.

Our overall plan for credit can be thought of in this way: credit reform will give us better information about the credit programs that we administer, and both loan asset sales and the credit management improvement initiatives will enhance the operation of those programs. In short, these efforts are designed to make better use of the taxpayers' dollar when it comes to Federal credit.

Mr. Chairman, thank you for hearing my views on this important and complicated proposal. I hope I was able to communicate that this proposal is an attempt to substantially improve the management of our Federal credit programs -- not to simply reduce the deficit. This concludes my prepared remarks. I would now be happy to answer any questions you or the Members of the Committee may have.

Chairman LAFALCE. Thank you very much, Mr. Wright. I am sure that we will have many questions for you, but we will defer those until we hear from the other panelists. Our next panelist will be Mr. Edward Gramlich, the Acting Director of CBO. Mr. Gramlich.

Mr. GRAMLICH. Thank you very much, Mr. Chairman.

Chairman LAFALCE. As with all witnesses, without objection, we will put the entire text of your remarks in the record. Hearing no objection, it is so ordered. We would like you to summarize your statement. That means that you should deliver it in less time than it would take to read it verbatim.

Mr. GRAMLICH. I think I get your drift, Mr. Chairman.

TESTIMONY OF EDWARD M. GRAMLICH, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. GRAMLICH. I will make three quick points in my oral statement. I would like to reemphasize the value of moving to proper treatment of Federal loans and guarantees in the budget. I will make two criticisms of the administration's proposal. We do support that, but we feel that they have not gone quite far enough, and I will say why. I will not cover in my oral testimony, although it is in the written testimony, the specific loans proposed for sale by the SBA.

Now, as was discussed in CBO's latest annual report and also in the analysis of the President's budget, the current budgetary treatment of Federal credit activities gives a misleading picture of program costs and can distort the Federal deficit.

These difficulties arise because cash-base accounting, designed to capture the costs of spending programs, is ill-suited to credit activity, which necessarily involves the exchange of cash now for promises to pay cash in the future.

This present treatment of Federal credit programs fails to produce useful information, because the current year cash-flows are an inappropriate measure of the costs of new direct loan and guarantee programs. Cash-flows are often incidental to and separated by time from the delivery of the subsidy.

It would be more informative if the budget included a grant equivalent measure of the cost of all current period loan obligations and guarantee commitments entered into in that year. That is the key—that we try to take these credit transactions and convert them to a grant equivalent, at least for budget accounting.

The best such measure is, as Mr. Wright said a second ago, the true subsidy cost of the present value of future defaults, interest losses, capital costs, and administrative expenses. Specifically, outlays would more closely approximate long-run costs, and the deficit would not be distorted by incidental monetary flows associated with credit transactions, if current period outlays, on the one hand, included the subsidy costs of new direct loans and new guarantees, but excluded new loan disbursements, repayments from old and new loans, repayments from the sale of loans, and disbursements to meet guarantee commitments.

In saying this, we are really saying nothing more than the President's Commission on Budget Concepts said way back in 1967 when

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it recommended many of the present changes in budget accounts that are now used.

Now, as we see it, there are two shortcomings in the administration's proposal, even though it is a step in the right direction. One is the budget accounting of the old loans that has been discussed already. And the second is that the administration's plan would also permit shortrun deficit reductions to be achieved by new credit initiatives which convert direct loans into guarantees and/or by refinancing existing loans with federally guaranteed private loans.

For example, if a direct loan were to be replaced by an equally subsidized loan guarantee, the true deficit would not be reduced, but the present cash-based deficit would still be reduced by the switch in the form of the credit transaction.

On page eight of my statement, we have done a calculation of what the budget would look like under the administration's proposals for 4 years. First, we have the top line which is the present cash-based deficit.

In effect, what that table does is to add in the credit subsidy cost, and it subtracts out net loan disbursements, and it adds in the loan sale receipts which are inappropriately subtracted out now.

And it arrives at our true deficit on the bottom line there. And if you just examine those numbers, you can see, basically, what is going on. I will not go through all of that for you. But the interesting thing is to note that in 1985, the true deficit was less than the cash deficit. In all of the other years, however, because of extensive use of loan sales, the true deficit is greater than the cash deficit.

In particular, in 1988 it is $8.7 billion greater than the cash-base deficit under the administration's plan. This would, as I am sure you have picked up, make it still harder to meet the Gramm-Rudman target of $108 billion this year if this change were adopted in this year.

I would think that it would be logical, if we moved to a new budgeting system, to also move to new Gramm-Rudman targets.

I will drop it right there, Mr. Chairman. I do have some comments on the SBA sale of loans, but I think that we want to focus mainly on this overall credit reform proposal. I think that I could say some more positive things about it. But it seems to me that most of the speakers this morning are saying positive things about it, so I will not bore you with that, and just leave it right there. Thank you very much.

[Mr. Gramlich's prepared statement follows:]

PREPARED STATEMENT OF EDWARD M. GRAMLICH, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to have the opportunity today to discuss the Administration's proposals for credit reform and pilot loan sales. I will make three points in my statement.

First, the current budgetary treatment of federal loans and guarantees is deficient and needs to be improved.

Second, the Administration's credit reform plan would substantially improve the treatment of new credit activity by substituting the subsidy cost of credit for the cash flows now shown in agency accounts. The Congressional Budget Office (CBO) believes, however, that credit reform should be carried one step further to correct the distortion in the deficit, as well as in the agency accounts, that results from all credit cash flows.

Third, the characteristics of the Small Business Administration (SBA) loan assets proposed for sale are such that they illustrate many of the advantages and difficulties of loan sales. On balance, these considerations suggest that SBA loans might be sold, without federal guarantees, in a manner that would not harm taxpayers or borrowers. The proceeds of these sales, however, should not be treated as deficit reduction.

SHORTCOMINGS OF CURRENT BUDGETARY TREATMENT OF CREDIT

As discussed in CBO's 1987 Annual Report and its Analysis of the President's Budgetary Proposals for Fiscal Year 1988, the current budgetary treatment

of federal credit activities gives a misleading picture of program costs and can distort the federal deficit. These difficulties arise because cash-based accounting, designed to capture the cost of spending programs, is ill-suited to credit activity, which necessarily involves the exchange of cash now for promises to pay cash in the future.

Under current cash-based accounting, when a loan by the federal government is disbursed to a borrower, the full amount is scored as outlays (increasing the deficit) just as if the loan were a grant. This treatment overstates the true cost of the loan because it ignores the repayments that the federal government expects to receive in the future. On the other hand, repayments are scored as offsetting collections (reducing the deficit) when received. As a consequence of netting disbursements and repayments, if repayments from old loans equal new disbursements, credit agencies may show net lending of zero in a year in which a large volume of deeply subsidized loans were originated.

Similarly, loan guarantees do not count as outlays until a default occurs. The substantial delay between commitment and outlays for guarantees results in an understatement of the costs of new guarantees, and the budget deficit, in the year in which the government commits itself to this liability. Treating guarantees on a cash basis requires that the current-year budget accounts show current-year guarantee fees as offsetting collections in the year received; they also show current disbursements to honor old guarantees.

A GENERAL SOLUTION

This present treatment of federal credit programs fails to produce useful information because current-year cash flow is an inappropriate measure of the cost of new direct loans and guarantees. Cash flows are often incidental to and separated by time from the delivery of the subsidy. Instead, it would be more informative if the budget included a grant-equivalent measure of the costs of all current-period loan obligations and guarantee commitments entered into in that year. The best such measure is subsidy cost--or the present value of future defaults, interest losses, capital costs, and administrative expense. Specifically, outlays would more closely approximate long-run cost and the deficit would not be distorted by incidental monetary flows associated with credit if current period outlays:

- Included the subsidy cost of new direct loans and new guarantees; but

- Excluded new loan disbursements, repayments from old and new loans, receipts from the sale of loans, and disbursements to meet guarantee commitments.

This observation is not new. The President's Commission on Budget Concepts recommended in 1967, for example, that only the subsidy elements in federal loans be included in the expenditure portion of the budget.

THE ADMINISTRATION'S PROPOSAL

By including the subsidy costs of new transactions in the agency accounts, the Administration's credit reform proposal takes a major step toward improving the budgetary treatment of credit programs. Credit subsidy costs of new credit activity would be reported in the agency budget accounts, and the associated cash flows for new loans and guarantees would be included in the account of a new revolving fund in the Treasury. Agencies operating federal credit programs would request annual appropriations equal to the amount of subsidy to be provided to borrowers during the fiscal year. As loans are originated and guarantee commitments issued, agencies would use these appropriations to pay the estimated subsidy value of those credits to the central revolving fund. The central fund would then disburse loans and make guarantee payments. It would finance these outlays with subsidy payments from the agencies, repayments, recoveries, loan sales, and with borrowing from Treasury.

Subsidy cost is defined as the additional payments a borrower would have had to make for a fully private, rather than a government-assisted, loan. The size of the subsidy can be estimated either by sampling market interest rates and performing the calculations or, more directly, by making and then selling loans, and by reinsuring guarantees with private insurers. The subsidy cost is the government's loss on the transaction: for loans, it is the amount advanced less the sale price; for guarantees, the insurance fee paid to the insurer less the fee collected by government from the borrower.

The Administration proposes that subsidy cost estimates could be obtained both by calculation and by sales and reinsurance. Loans that could be readily sold would be marketed to investors. Where private credit insurance is available, the government would reinsure its risk. In the case of loans regarded as unsuitable for sale, such as those to foreign countries and for uninsurable guarantees, the central fund would calculate the subsidy and charge the agencies that amount.

A serious misconception exists among some critics of the plan who assert that market transactions will always overstate true subsidy costs because private financial firms have higher costs than the federal government. These higher costs are attributed to federal taxes paid by private firms and a higher cost of money.

It is doubtful that government costs are lower than private costs in any economically or socially meaningful sense. To have the government hold loans because it is exempt from federal taxation is a false economy. Government is the recipient of these higher costs. The higher cost of borrowed money for private firms is also irrelevant to the pricing of financial assets. Private financial firms, for example, whose cost of money is higher than the government's, purchase billions of dollars of U.S. Treasury securities that yield only "the government's cost of money." It is important to recognize also that the use of capital has a cost no matter who is using it. Finally, government, like all other entities, must use a risk-adjusted interest rate to discount risky income streams. In sum, I am unaware of any

evidence that market prices for federally-originated financial instruments would be consistently biased because private costs are higher than the government's cost.

SHORTCOMINGS OF THE ADMINISTRATION'S PROPOSAL

While it is a step in the right direction, the Administration's proposal does not go far enough in reforming the budgetary treatment of credit transactions. There are two shortcomings:

- The proceeds from sales of old loans will still be scored as short-run deficit reductions even after credit reform. The Administration's proposal for loan asset sales from the existing loan portfolio is projected to reduce the deficit by more than $5 billion in 1988. The proceeds from such transactions result in deficit reduction because they represent accelerated loan repayments that will be scored as offsetting collections. Under the logic of their own proposal, however, the budget deficit should not be affected by the receipt of repayments already expected or induced prepayments of existing loans.

- The Administration's plan would also permit short-run deficit reductions to be achieved by new credit initiatives which convert direct loans into guarantees and/or refinance existing loans with federally guaranteed private loans. For example, if a direct loan were to be replaced by an equally subsidized loan guarantee, the

true deficit would not be reduced, but the present cash-based deficit would still be reduced by the switch in the form of credit assistance. Similarly, refinancings of existing loans with federally guaranteed private borrowing would still result in a short-run deficit reduction even though a new subsidy cost is charged.

AN ADDITIONAL REFORM STEP

One way to immunize budget outlays and the deficit from the distorting effects of repayments, existing guarantee disbursements, asset sales, and switches from direct loans to guarantees would be to include subsidy cost in the agency accounts, as the Administration has proposed, and make the further reforms proposed above.

The consequences of such a change for the budget deficit are illustrated in Table 1, which uses data from the President's proposed budget for 1988. For example, the first line of the table shows the current cash-based deficit of $212.3 billion in 1985. Then, it adds subsidy cost of $16.3 billion, which is the objective of credit reform. Next, net loan disbursements of $32.5 billion, which inappropriately increase budget outlays and the deficit, are subtracted. Similarly, loan sale receipts of $1.5 billion are added to the deficit because they have been used to reduce inappropriately the cash-based deficit. In our view, the adjusted deficit of $197.6 billion is a more meaningful measure of the changes in the financial condition of the government.

The difference between the Administration and CBO proposals is that, whereas the Administration would substitute subsidy cost for cash flows in the agency accounts, it would not permit this substitution to affect total outlays and the deficit. The CBO proposal is an "additional step" in that it extends this substitution to the entire budget. In order to dispel the incorrect notion that this change somehow moves federal credit off-budget, the recommended budget structure that incorporates this change again for the 1985-1988 period is shown in Table 2.

TABLE 1. EFFECT ON THE DEFICIT OF SUBSTITUTING SUBSIDY COST FOR CREDIT CASH FLOWS, 1985-1986 ACTUALS, AND THE PRESIDENT'S PROJECTED AND PROPOSED BUDGETS, 1987-1988 (By fiscal year, in billions of dollars)

	1985	1986	1987	1988
Cash-Based Deficit	212.3	220.7	173.2	107.8
Credit subsidy cost	16.3	16.9	15.0	12.7
Less: loan disbursements (including outlays for guarantees, net of repayments, recoveries, and fees)	-32.5	-15.2	-15.0	-10.6
Plus: loan sale receipts (less reinsurance premiums paid)	1.5	1.6	6.0	6.6
Deficit	197.6	224.0	179.2	116.5

SOURCE: Congressional Budget Office; Office of Management and Budget.

NOTE: Excludes Commodity Credit Corporation price support loans from credit; also excludes subsidy cost for GNMA secondary guarantees. Details may not add to totals because of rounding.

The credit revolving fund shown in the next to last line is the fund proposed in the Administration plan, but here includes credit cash flows from old as well as new loans and guarantees. The total financing requirement and borrowing from the public is not affected by this accounting modification. This is a sensible result inasmuch as no real change in activity results from a mere accounting adjustment.

The consequences for the deficit of this restructuring, however, are significant. Using the President's budget figures, the deficits for 1987 and 1988 increase by $6.0 billion and $8.7 billion, respectively. Adding in other CBO reestimates of the President's budget, the deficit for 1988 under Administration policies would be in the neighborhood of $142 billion. If this accounting convention were adopted, therefore, some revision of the deficit targets in the Balanced Budget Act might be necessary.

TABLE 2. RECOMMENDED BUDGET STRUCTURE (By fiscal year, in billions of dollars)

	1985	1986	1987	1988
Revenues	734.1	769.1	842.4	916.6
Expenditures				
Direct spending	915.4	976.2	1,006.6	1,020.4
Credit subsidies	16.3	16.9	15.0	12.7
Total expenditures	931.7	993.1	1,021.6	1,033.1
Deficit	197.6	224.0	179.2	116.5
Credit Revolving Fund	14.7	-3.3	-6.0	-8.7
Total Financing Requirements	212.3	220.7	173.2	107.8

SOURCE: Congressional Budget Office; Office of Management and Budget.

Carrying out the Budget Commission recommendation for credit effectively protects the budget from distortion by disbursements, repayments, and loan asset sales. In addition, this change will assure that if loan asset sales are carried out, it will be for programmatic reasons rather than artificial "deficit reduction."

PROPOSED SALES OF SBA LOANS

It is important to distinguish the Administration's proposal for credit reform from the pilot sale program for loans. Although newly originated SBA loans would be sold under credit reform, the Administration proposes to sell SBA loans from three programs, independently of credit reform, as shown in Table 3. These are general business loans, disaster loans, and SBA-guaranteed, Federal Financing Bank (FFB) originated development company loans. In 1988, the face value of loans proposed for sale, and artifical deficit reduction, exceeds $2 billion. The aggregate, however, obscures a wide range of variation in loan characteristics.

TABLE 3. PRESIDENT'S PROPOSED SBA LOAN ASSET SALES 1987-1990
(By fiscal year, in millions of dollars)

	1987	1988	1989	1990
Business Loan Investment Fund	0	1,000	1,000	0
Disaster Loans	600	670	670	670
Development Companies	0	500	397	0

SOURCE: Office of Management and Budget.

The loans to development companies for commercial real estate purchase, construction, renovation, and development are relatively large (they average $200,000), bear fixed interest rates in excess of 10 percent, with maturities of up to 25 years, and are fairly well documented. The general business loans are about half as large in principal amount as the development loans, have an average interest rate in excess of 8 percent, and have maturities up to 30 years. The disaster loans average $21,000 in outstanding balances, bear an average interest rate of less than 5 percent, and are often poorly secured. Over 200,000 of these disaster loans are outstanding to individuals, farmers and small businesses.

The prospect of selling these loans raises several programmatic and technical questions. The principal programmatic concern appears to be the possible loss of forbearance granted by SBA to the borrower. That is, SBA has--in virtually all of its loan programs--adopted a policy of being more lenient with borrowers than is consistent with either the loan contract or minimizing the loss to the government. Private investors may not be willing or able to continue these practices. Two possible means of continuing the present level of forbearance after sale are: (1) originating new loans to troubled borrowers on terms that reflect the desired degree of leniency or (2) specifying conditions of forbearance in the loan sale contract.

A second concern is whether it would be feasible to sell 200,000 individual disaster loans, many of which are poorly collateralized. This same concern applies to the 4,000 development company loans and also

reflects the high cost that would be incurred if the government attempted to provide the information necessary to evaluate each loan to each potential buyer.

A third concern is raised by the diversity of loans within and among the various program portfolios. Some of the loans mature within a year; others have 25 years or more to run. Most borrowers are current in their payments, but over $1.5 billion in general business loans are more than 90 days in arrears on payments. The fear is that such a hodge-podge of credits will appeal to no one and that any sale will occur at very low prices.

A technical solution to the latter two concerns about cost of information and portfolio diversity may be provided by the multiclass collateralized security. The portfolios could be sold, under competitive conditions, in large pools, to an investment banking firm that would issue securities backed by the loans. The securities might consist of three classes. Class I would be entitled to a fixed rate of interest and would receive all principal repayments from the pool until their investment was returned and their securities retired. Class II would receive only interest payments until the Class I securities were retired. Class III security holders would be the last to receive principal repayments and, hence, would be the residual absorbers of all risks.

Multiclass collateralized securities have the advantage that the government would have to provide detailed information about the loans to only a few dozen firms rather than all potential investors. Moreover, the

securities issued from the same pool can have vastly different maturity and risk characteristics. This factor enables the government to obtain the advantage of tailoring the securities to the demand of various investors. Class I securities, for example, would appeal to the most conservative investors, while Class III would have more speculative characteristics. The pool arrangement also lends itself to private credit enhancement such as is provided by a standby letter of credit or a surety bond. Also, the securities can be registered so that secondary markets can develop for these issues. The development of such markets would enhance the liquidity of the securities and enable the "after-sale" price to be monitored. These advantages are such that virtually all of the loan sales proposals that have been made to the government propose the use of multiclass collateralized securities.

A fourth concern is whether federally-originated loans should be sold with recourse to the government. CBO believes strongly that loan sales should be without recourse or other federal guarantees. Only final sales will reveal the real subsidy conveyed by the loan. On this matter, your letter requested my reaction to the GAO report: Loan Asset Sales, OMB Policies Will Result in Program Objectives Not Being Fully Achieved, September 1986. This report is a criticism of the OMB guidelines for loan asset sales. In particular, GAO alleges that the OMB prohibition on federal guarantees will reduce the net proceeds from loan asset sales. As evidence, GAO cites a proposal for the sale of a college housing loan in which the government purportedly could receive an additional $220 million in cash now for

agreeing to issue a guarantee with a future "estimated maximum risk to the government" of $60 million. From this case, GAO argues that "sales without recourse provisions could artifically depress proceeds" and urges that recourse to the government be permitted by loan investors.

The GAO report is deficient in at least three respects. First, the effect on the net proceeds to the government of selling with a guarantee is mixed with the effect of converting the individual loans into securities. CBO agrees that the successful purchaser of federal loan assets is likely to use the multiclass security approach and that the sale price will reflect the potential gains from security financing. This packaging makes a federal guarantee unnecessary and still provides the information the government needs. Second, GAO appears to base its recommendation for recourse on the assumption that unexploited opportunities for profit will persist in financial markets. It is inconceivable that investors will be willing to pay or insurers able to charge $220 million for $60 million of insurance. A long-term policy for loan sales should not be based on such an assumption. Third, the GAO report does not explain how partial guarantees would enable the market to assess these loans more accurately. More accurate assessment will result from better information, not from guarantees. If the government has useful information about these loans, it should make it available. Loan asset sales with recourse are a high-cost form of government borrowing that yields no program benefits. Rather than sell assets with recourse, it would be less costly for Treasury to borrow directly from the public. I would suggest, therefore, that the GAO report does not provide any grounds for revising the OMB guidelines.

Chairman LAFALCE. Thank you very much, Mr. Gramlich. Our next witness will be Mr. Frederick D. Wolfe, Director of GAO's Accounting and Financial Management Division. That division recently was responsible for a GAO report entitled "Loan Asset Sales, OMB Policies Will Result in Program Objectives Not Being Fully Achieved." Mr. Wolf.

TESTIMONY OF FREDERICK D. WOLF, DIRECTOR, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION, GENERAL ACCOUNTING OFFICE

Mr. WOLF. Thank you very much, Mr. Chairman. Let me just summarize a couple of points. As you noted, the program to sell existing loans is attempting to raise $5 billion in 1987 and $6 billion in 1988 through a series of pilot programs in several agencies, although I would point out that to date we have not made any sales under that program.

The administration's proposals for further credit reform involve a market plan approach under which all direct loans would be promptly sold without guarantee or recourse, and a change in budgetary scorekeeping to score the subsidy component of the loan rather than at present where we treat the entire loan as a cost to the Government when we make it.

Based on our work over the past 2 years, we believe that improvements in both credit management and in budget scorekeeping are needed, and we welcome initiatives to accomplish this.

A judicious use of sales of certain portfolios or portions of those portfolios is one means to achieve some of the needed improvements. We have, however, several cautionary notes. First of all, selling loans—which, as we have discussed this morning, is viewed by some as a means to reduce our deficit—will not do anything to alter the fundamental deficit position which we have. Second, by not providing some form of limited recourse, we will in some cases unnecessarily reduce the Government's proceeds if we sell portfolios. Third, we need to ensure that borrowers' rights under the law and under policies are not abridged in any way in the process of selling the loans.

An across-the-board provision to sell all loans immediately may result in some sales which are not in our best interests. Some discretion in this area is warranted.

And probably, a more indepth review is needed of each portfolio and the cash-flows that would be received on the sales in order to determine whether it is advantageous to undertake the sales.

We are doing such a review of several portfolios right now, and would hope to be reporting on that by the end of this month or early next month.

As regards changing the budgetary treatment, we strongly support a chance to score subsidies rather than the full loan, but we do differ from the administration on a couple of points. We believe that the subsidy should be based on the Government's cost rather than some mythical benefit to the borrower which has been discussed.

And we believe that scoring loan sales which have just a partial guarantee as a borrowing is not appropriate. If it is a guarantee,

then consistent with some of the other suggestions, we ought to score the cost of the guarantee. But just saying that a minor guarantee means a borrowing rather than a sale does not make sense.

Those are, I guess, the important points that I would want to focus on to you this morning. Thank you very much.

[Mr. Wolf's prepared statement follows:]

PREPARED STATEMENT OF FREDERICK D. WOLF, DIRECTOR, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION, GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our assessment of the administration's current pilot sale of existing federal loan assets under the OMB guidelines and fiscal year 1988 sales plans. In September 1986, we testified and reported[1] on our review of OMB's guidelines for the sale of federal loan assets to Chairman Brooks, House Committee on Government Operations, Legislation and National Security Subcommittee. We said that OMB policies will result in loan asset sales pilot program objectives not being fully achieved. Since our report was issued, we have testified several times that OMB's loan sale guidelines will not result in the government maximizing the net proceeds of loan sales. In recent testimony we pointed out that over the long term, the government may be forgoing revenue to meet short-term deficit reduction goals.

OMB's original proposal to sell loan assets was presented in the fiscal year 1987 budget request. The proposal called for selling $4.4 billion in Federal loan assets on a pilot basis before embarking on a full-scale sales effort that would reform Federal credit programs by

-- reducing the government's cost of administering credit by transferring servicing, collection, and other administrative activities to the private sector;

-- providing an incentive for agencies to improve loan origination and documentation;

-- determining the actual subsidy of a Federal credit program; and

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[1] Loan Asset Sales - OMB Policies Will Result in Program Objectives Not Being Fully Achieved. GAO/AFMD-86-79, September 1986.

-- increasing unified budget offsetting collections in the year of sale.

Subsequent to OMB's original sales proposal, the Congress passed the fiscal year 1987 Budget Reconciliation Act, which directed the Administration to sell enough loan assets, within certain programs, to generate initially an estimated $6.8 billion in revenue. As a result, the administration's pilot sale program was modified with the sale of certain loan portfolios being deferred from fiscal year 1987 to fiscal year 1988 so that sales of other loan portfolios required by the act could be accomplished. Accordingly, $9.3 billion in loan assets are to be sold during fiscal year 1987 with a currently projected return of $6.3 billion, and $12.5 billion in loan assets are to be sold during fiscal year 1988 with projected return of $5.9 billion. To date, however, no loan asset sales have taken place.

In our September 1986 testimony and report, we pointed out that OMB's loan sale guidelines and proposed policies would not protect the government's interests and would preclude the government from fully achieving the objectives of the pilot sale program. We, therefore, recommended among other things that OMB revise its loan sale guidelines to permit agencies to sell loan assets on a structured basis and to allow agencies, where appropriate, to conduct sales with some form of future recourse to the government.

OMB, in responding to our report, commented that it would permit recourse sales if the primary objective of loan sales was to generate receipts. OMB's position, however, is that the primary objective of its pilot loan sale program is credit reform and not raising receipts, and consequently, OMB still requires nonrecourse sales. The provisions, however, relating to the sale of loan assets in The Fiscal Year 1987 Budget Reconciliation Act

and the President's fiscal year 1988 budget request, which look to the sale of loan assets to generate cash receipts to help close the budget deficit, have shifted the emphasis of loan sales from a credit reform tool to a revenue enhancement tool.

SALES PROCEEDS WILL NOT BE MAXIMIZED

A major focus of loan asset sales, in our opinion, in both the fiscal year 1987 Budget Reconciliation Act and in the President's fiscal year 1988 budget request is to generate receipts to help reduce the budget deficit. Consequently, we believe that sales of loan assets should be made on a basis that produces the maximum proceeds. Because OMB's guidelines still require that loan asset sales be made without future recourse to the government, the result will be that the proceeds from the sales will not be maximized.

In September 1986, we reported that our analysis of the secondary credit markets--the means established by the financial community for trading mortgage and nonmortgage loans and related securities--showed that any loan asset sales, with or without recourse, should be structured as a pool of loans rather than as individual loan sales. This is because major investors want to deal in large dollar volumes. Certain loan pools could be successfully sold without government recourse. These loans would include the types that investors are familiar with, such as residential mortgage loans. There was unanimous agreement among the secondary credit market representatives that OMB's guidance to sell loan assets without any form of recourse to the government would result, in many cases, in artifically depressing net sale proceeds and in the government not realizing the maximum possible proceeds.

Our report pointed out that some form of recourse sale is needed to maximize sale proceeds because investors are not familiar with the various types of government loans being sold and borrowers under certain government programs do not--often by definition--meet commercial lending standards for creditworthiness. In addition, the government experiences high loan default rates for many of its loan programs. Finally, government loans are not always supported by adequate documentation.

Consequently, we reported that for government-held loan portfolios that have any of the above characteristics, consideration should be given to allowing sales on a "structured basis" with "credit enhancement." Let me briefly explain these concepts.

A "structured basis" for selling loan assets usually includes

-- forming a pool of loans with similar terms, interest rates, and established default rates;

-- creating a new security, such as a bond, which has the principal and future interest payments of the loans in the pool as collateral--in other words, create a "collateralized security"; and

-- arranging for a commercial organization to collect periodic principal and interest payments from borrowers under the pool and remit funds to the security issuing entity for subsequent payment to investors.

"Credit enhancement" for a security could include such techniques as the Government's pledge to guarantee or indemnify investors for a certain percentage of defaults on loans in the

pool based on default rates experienced for the pooled loans at the time of sale. This alternative would have the government and the investors in the loan portfolios share the potential risk of borrower default.

Our September 1986 report pointed out that both the Department of Housing and Urban Development and the Veterans Administration have experience with loan sales. During our discussion with these agencies, we were told that both agencies have concluded that loan sales without recourse would result in lower expected proceeds. Specifically, the price investors would bid for a portfolio on a sale without recourse would fall by more than a reasonable estimate of the future cost of providing recourse.

In addition, we reported that one of the larger loan portfolios proposed for sale is the Department of Education's college housing loans. Education contracted with a consultant to study the loans prior to sale. The consultant's report discussed two methods of selling the loans: selling loans in separate portfolios without recourse, and pooling loans as collateral for a new issue of a security with a limited guarantee as a form of recourse.

The consultant estimated that the loan-backed security sale would provide the greatest proceeds. Net proceeds from the separate portfolio sale without recourse would be about $1.1 billion, while the net proceeds from the sale of a security with a limited guarantee would be about $1.3 billion. Issuing a new security with a limited guarantee backed by the loan pool would therefore increase net proceeds by at least $220 million. We estimate that the maximum guarantee risk associated with this sales method would be about $59.8 million, leaving about $160 million in unencumbered additional proceeds.

ACTIONS NEED TO BE TAKEN
TO AVOID UNINTENDED EFFECTS
ON BORROWERS

OMB's pilot loan sale guidelines require that servicing of loan portfolios that are sold be transferred to the investor. The investor, in turn, could contract with a private loan servicing company to handle day-to-day loan servicing activities. Care needs to be taken in transferring loan servicing from the government to private loan services so that borrowers would not be affected in any way counter to their lawful rights or the policy of the government. Without adequate guidelines and sale provisions, portfolio sales could have unintended consequences for borrowers. For example, the government may, as a matter of policy, adopt certain debt collection and refinancing policies for a certain class of borrowers. Sales to private lenders, without adequate guidelines and sales provisions, could subject borrowers to collection and refinancing policies that could work against the original intent of the loan programs.

CREDIT PROGRAM SUBSIDIES FOR NEW LOANS
WILL NOT BE ACCURATELY MEASURED

We believe that the subsidy costs to the government for credit programs should be measured and reflected in the budget. This is a positive step in federal credit reform. However, we believe that the administration's plan for determining subsidy amounts will result in overstatements of subsidies. Specifically, the direct loan subsidy amount that would be reported and budgeted for would be the difference between the face amount of a direct loan and the amount the government receives in selling that loan on a nonrecourse basis. The idea according to material provided to us is to measure the subsidy "based on the benefit to the borrower." Presumably, the purchase

price would approximate the loan amount that the borrower would have been able to get on the open market, and the difference between that and the higher face amount of the government loan would be the subsidy benefit conferred by the loan.

Unfortunately, this would not provide a measure of the actual cost to the government of making that loan. In all likelihood, the subsidy benefit so calculated would be larger than the actual subsidy cost to the government of making that loan.

We think that for budgeting purposes, the subsidy measure should reflect the cost to the government of credit activities, not the subsidy benefit provided to the borrowers. We have two reasons for favoring this approach. First, measuring subsidy costs to the government would be consistent with a primary function of the federal budget, which is to provide a statement of the costs (in outlays) of governmental operations. If the budget measured something other than the costs to the Treasury of programmatic decisions, it would become a more confusing document. We agree that it is important to know what benefits are conferred by credit activities, but this should be done outside of the budget's totals.

The second reason for favoring the measurement of subsidy costs rather than subsidy benefits is that the former approach would correct a problem in current budget scorekeeping conventions. At this time, the budget treats direct loan and regular expenditure programs alike even though they are different in a key way: True direct loans entail some repayment of funds to the government. To better compare the costs of the two kinds of programs, it would be necessary to focus on that part of the loan programs that represents the net cost to the government--in other words, the subsidy cost. Reporting subsidy costs would

permit lawmakers to make valid comparisons between loan and regular expenditure programs.

As we have stated elsewhere,[2] the best measure of the subsidy cost would essentially be the difference between the borrowing cost incurred by the government when it financed the loan, and the present value (at that time) of the borrower's future repayments. This would tie subsidy recognition to interest rates and the government's cost of money at the time it made the loan.

In contrast, the administration's focus on subsidy benefits in effect shifts the calculation to interest rates and the private investor's cost of money at the time of the loan sale. The private investor's cost of money would be built into the investor's computation of the present value of the borrower's future repayments. This would determine the price the investor is willing to pay.

Because the investor's cost of money would be higher at any time than the government's--the government is a better credit risk--the present value to the investor of a future repayments stream likely would be less than the present value of that same income stream to the government. This alone would make the loan worth less to the investor than to the government and have the effect of depressing the purchase price.

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[2]Statement of Charles A. Bowsher, Comptroller General of the United States, before the Legislation and National Security Subcommittee, House Committee on Government Operations, September 26, 1986; and GAO comments on S. 2142 provided to the Chairman, Senate Committee on Governmental Affairs, December 8, 1986. Statement of Frederick D. Wolf, Director, Accounting and Financial Management Division, before the Committee on The Budget, United States Senate, March 4, 1987.

In short, basing the subsidy calculation on the private investor's lower present value would likely result in a subsidy amount higher than the actual subsidy cost to the government. This would reflect the realities of the private market at the time of the sale but would not reflect the subsidy cost to the government when officials originally made the loan. Our approach would recognize the costs to the government when the loan was made. This, by the way, is the approach that was recommended in 1967 by the President's Commission on Budget Concepts.

LOAN SALE'S IMPACT ON
BUDGET DEFICIT

With regard to reducing the federal deficit, we feel that the market plan for selling new loans could potentially have very different effects on short- and long-run budget deficits. The immediate effect of selling loans would be to accelerate cash collections and thereby reduce the deficit in the short run. However, if the proposal's requirements--that all new loans be sold promptly and without recourse--artificially depress sale proceeds, the immediate, positive effect on the deficit could be more than offset by a longer run increase in the deficit. Even after adjusting for the time value of money, the stream of repayments that the government forgoes by selling a loan could be worth more than the revenue derived from the sale of the loan. We are currently studying this issue on several specific portfolios for another committee and expect to provide testimony on the subject in late March or early April.

PROPOSED BUDGET TREATMENT OF LOAN SALES
IMPEDES MAXIMIZING SALE PROCEEDS

OMB's proposed budget classification for loan sale proceeds is an impediment to agencies selling loan assets with recourse

and thereby maximizing sales proceeds. Specifically, OMB proposes to classify loan sale proceeds as deficit reducing receipts only if the sales are made without recourse to the government. However, if sales are made with any recourse to the government, no matter how limited, the sale proceeds are to be classified for budget purposes as borrowings rather than as receipts. Consequently, if sales with any form of recourse are made, the sales will not be considered as having contributed to deficit reduction. The proposed classification procedure reinforces OMB's guidelines, which call for loan sales without recourse.

We believe that under a limited recourse loan sale, the portion of the sale proceeds that represents the estimated amount the government would have to pay under the limited recourse provisions should be treated for budget purposes as borrowings. The balance of the sale proceeds should be treated as receipts. This approach is consistent with GAO's position on budget treatment for other federal loan guarantee programs, which is that a guarantee should be accounted for at its estimated cost to the government.

We believe that OMB loan asset sale guidelines do not place sufficient focus on maximizing sales receipts. Further, OMB's proposed budget treatment of loan sales impedes the sale of loans with recourse. We also believe that the costs to the government of credit programs should be used when measuring subsidies.

We are still doing work in the areas discussed under a request from Chairman Brooks. Our ongoing work includes reviews of specific loan portfolios to determine loan loss rates and to assess their marketability. We expect to report more on this and other matters when we complete our review this spring.

This concludes my formal remarks. I will be pleased to answer any questions you or other members of the Committee may have.

Chairman LAFALCE. Thank you, Mr. Wolf. Our final witness will be the Commissioner from the Securities and Exchange Commission, the Honorable Edward Fleischman. Mr. Fleischman.

TESTIMONY OF HON. EDWARD H. FLEISCHMAN, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Mr. FLEISCHMAN. Chairman LaFalce and members of the committee, the Securities and Exchange Commission is pleased to testify concerning the applicability of the Federal securities laws to the sale of the Federal Government loan assets mandated by the Omnibus Budget Reconciliation Act of 1986. We are grateful for your inclusion of our written statement in the record, Mr. Chairman.

The principal purposes of the Federal securities laws are to protect investors and to maintain fair and orderly securities markets. How the securities laws apply to loan sales depends on how the loan sale transactions are structured and consummated.

If an offering requires registration and the registration statement is well prepared by experienced securities advisors, it should become effective within a period approximating 30 days after the filing.

If the registration statement requires major modifications, it will depend on how long it takes the issuer to provide the requisite information summarized in our written testimony. Possible exemptions from registration and some of the advantages of registration are also summarized in our written testimony.

Generally, the costs of a registered and underwritten public offering would be greater and the process may take longer than a nonregistered best efforts private placement of securities with institutional investors.

However, registration costs may be more than offset by the benefits of registration, including the possibility of a higher price for the securities. Registration does permit a broad public distribution to a greater number and range of institutional and individual investors, and also the creation of an active public market in the securities.

Further, it is common in unregistered private placements for institutional investors to require similar and sometimes more detailed information than that required in a registration statement, as well as more stringent terms and a lower price—justified in part by the lack of liquidity.

Investors cannot subsequently sell most types of unregistered securities in the open market. All other things being equal, illiquid securities may sell at a 10 percent or larger discount from the price of liquid securities. Such a discount would significantly exceed the greater cost of a registered offering.

Also, compliance with registration requirements facilitates comparative analysis of the securities offered with other publicly traded issues.

There are also possible tax advantages to investors if interests in the loans are structured for compliance with the Investment Company Act. Regulated investment companies are not subject to a separate Federal corporate income tax. Distributions of dividends, interest and capital gains by investment companies are subject only

to the Federal tax payable by companies' shareholders as if the shareholders held the company's portfolio securities directly. The recent so-called REMIC provisions of the Tax Reform Act of 1986 may provide an alternative method for certain loan sale transactions to achieve favorable flow-through tax treatment.

For all of the foregoing reasons, we think the financial advisors and legal counsel to the agencies must analyze carefully the size and nature of each financing, the quality of the loans to be sold, and then-current market conditions, in order to determine whether a registered public offering—through an investment company or otherwise—a nonregistered private placement—or another type of exempt offering—or a combination of these alternatives, is the most advantageous means of selling large whole loans or packaging and marketing a portfolio of loans.

As you would expect, Mr. Chairman, the Commission and its staff are prepared to cooperate with and assist the agencies and, of course, this committee, in effecting the loan sale transactions in compliance with the Federal securities laws. Thank you, Mr. Chairman.

[Mr. Fleischman's prepared statement follows:]

PREPARED STATEMENT OF HON. EDWARD H. FLEISCHMAN, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Chairman LaFalce and Members of the Committee:

I. INTRODUCTION

The Securities and Exchange Commission is pleased to testify about the applicability of the federal securities laws to the sale of the federal government loan assets mandated by the Omnibus Budget Reconciliation Act of 1986.

The principal purposes of the federal securities laws are to protect investors and to maintain fair and orderly securities markets. How the securities laws may apply to the loan sales depends upon how the transactions are structured and consummated.

The Commission staff is prepared to cooperate and assist the agencies in selling their loans in compliance with the federal securities laws. If an offering requires registration and the registration statement is well prepared by experienced securities attorneys, it should be possible for the registration statement to become effective within thirty days after filing. If the registration statement requires major modifications, it will depend upon how long it takes the issuer to provide the requisite information summarized herein. Possible exemptions from registration and some of the advantages of registration are also summarized herein.

II. BACKGROUND

The President's Budget for Fiscal 1987 proposed a pilot program to sell portions of 13 federal government loan portfolios. The program was proposed as part of the federal effort to reach the Gramm-Rudman-Hollings FY 1987 deficit target of no more than $144 billion.

On July 8, 1986, the Office of Management and Budget issued guidelines, developed by the Federal Credit Policy Working Group, for agencies to follow in selling loan assets. The guidelines provide that loan asset sales shall be made without future recourse to the federal government, loans of tax-exempt entities shall be sold only if the future interest payments on the loans are subject to federal income tax, and collection and servicing shall be transferred to the private sector. Additionally, the guidelines provide that, in limited circumstances, agencies may offer certain borrowers that are current the right to purchase their loans. The guidelines also provide that the timing of the sales, the composition and size of loan pools, and other "marketing issues", shall be handled individually by each agency and will vary from portfolio to portfolio depending on market conditions.

On October 21, 1986, the Omnibus Budget Reconciliation Act of 1986 was signed into law. The Act adopted the loan asset sales program proposed in the President's Budget for Fiscal 1987,

with certain modifications. Modifications to the President's proposal included the specific portfolios to be sold, the fiscal years during which the portfolios are to be sold, and the amounts to be realized through the sales. The Act mandates that, under such terms as the agencies selling the loans may prescribe, certain agencies must sell portions of their loan portfolios sufficient to raise a combined total of approximately $5 billion in FY 1987. Pursuant to this legislation, the following agencies must net the following approximate amounts during Fiscal 1987: the Farmers Home Administration ("FmHA") $1 billion from loans of the Rural Development Insurance Fund it administers and $1.7 billion from its rural housing fund loans; the Department of Education ("DOEd") $579 million from its college housing loans; the Export-Import Bank $1.5 billion from its loans; and the Economic Development Administration $50 million from its loans. The OMB guidelines provide these agencies guidance in effecting the loan sales.

The President's Fiscal 1988 Budget recommends loan sales in FY 1988 that OMB has estimated will produce receipts of $5.3 billion to the government. The loans would be sold from the portfolios of the following agencies: the FmHA; the DOEd; the Rural Electrification Administration; the Small Business Administration; the Department of Housing and Urban Development; the Veterans Administration; the Export-Import Bank; the Bureau of Reclamation; the Department of Health and Human Services; the Department of Transportation; and the Tennessee Valley Authority. The loan sales would be part of the federal effort to reach the Gramm-Rudman-Hollings FY 1988 deficit target of $108 billion.

III. METHODS OF STRUCTURING SALES UNDER CONSIDERATION

The Omnibus Budget Reconciliation Act does not prescribe precisely which agency loans are to be sold or the manner in which the sales are to be made. Each agency may, consistent with the OMB guidelines, select those loans it proposes to sell from the portfolios specified by Congress and determine the most appropriate means of structuring the sales. In accordance with the OMB guidelines, both the FmHA and the DOEd have, through a competitive process, selected financial advisors on the sales.

The Commission's staff has had preliminary discussions with the FmHA regarding plans under consideration for the sale of loans from its Rural Development Insurance Fund to local governmental units and certain not-for-profit organizations such as farm cooperatives. Under a Request for Proposals ("RFP") dated December 15, 1986, the FmHA has sought proposals from prospective underwriters or purchasers of such loans. The RFP seeks specific proposals on how best to structure the sales and a marketing plan which "[m]aximizes the price paid to the federal government, and [which] [m]ay be fully and easily replicated in future sales." The RFP clarifies that the FmHA will select rural development loans for sale by random selection. */

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*/ The size and nature of the loans is likely to have a significant impact on how loan sales are structured. According to a preliminary portfolio analysis prepared for the FmHA in November 1986, approximately 42% of its rural development loans are less than $100,000, approximately 43% are $100,000 to $499,999, approximately 9% are $500,000 to $999,999, and approximately 6% are $1 million or more.

The Commission's staff also has had preliminary discussions with the DOEd regarding that agency's proposed sales of loans from its college housing loan portfolio. */ These loans to colleges were for the construction of student and faculty housing.

FmHA and DOEd representatives have advised the Commission's staff that they are considering the sale of "whole" and of "pooled" loans. **/ In a "whole" loan sale, a particular loan or package of loans would be sold outright to purchasers. In a "pooled" loan sale, interests in a pool of such loans would be sold to the purchasers. The FmHA has considered selling pooled loans through a separate entity whose assets would consist of the loan portfolio. This entity would take the form of a grantor

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*/ According to the DOEd, a July 1986 asset evaluation determined that the average size of the dormitory loans in the college housing loan portfolio is $709,164. There are 3,076 loans in the portfolio, which were made to a total of 1,172 schools.

**/ The Commission's staff has not been apprised of plans for structuring loan assets sales that may be under consideration by the Economic Development Administration or the Export-Import Bank. The Reconciliation Act specifically amended the Export-Import Bank Act to define the sale of Export-Import Bank loans as a sale of exempted securities within the meaning of Section 3(a)(2) of the Securities Act and Section 3(a)(12) of the Securities Exchange Act. However, the Reconciliation Act provides that the Export-Import Bank shall file with the Commission such annual and other reports regarding these securities as the Commission deems appropriate in view of the nature of the Bank and as necessary in the public interest or for the protection of investors. The Reconciliation Act does not provide an exemption from the provisions of the Investment Company Act of 1940.

trust or a single-purpose finance corporation. Under a grantor trust, purchasers would be sold undivided interests in the form of equity certificates of participation in the trust, or debt obligations of the trust. Under the single-purpose finance corporation approach, the entity would purchase a portfolio of FmHA loans and would sell its own equity or debt securities to investors.

IV. APPLICATION OF THE SECURITIES LAWS

The manner in which loan sales are structured and sold will determine the extent to which the sales are governed by the federal securities laws. The following discussion generally describes how the relevant securities laws may apply to the sales currently under consideration by the FmHA and the DOEd.

SECURITIES ACT OF 1933

General

The Securities Act of 1933 has two objectives: to provide full and fair disclosure concerning securities sold to the public, and to prevent fraud in the sale of such securities. The Securities Act requires that nonexempt offerings of securities to the public be registered with the Commission. The registration statement must contain specified information about the securities being offered, the issuer of the securities and the manner in which the securities will be distributed. No sale of registered securities may be completed prior to the registration statement becoming

effective, or prior to the delivery of a prospectus to the purchaser that contains the basic information included in the registration statement.

The Securities Act imposes civil and criminal liabilities for material misstatements or omissions in the registration statement or prospectus. There also are general antifraud provisions -- enforceable by injunction and criminal sanctions, as well as private lawsuits for damages -- that apply whenever a security is sold, whether or not sold pursuant to a registration statement. The civil remedies under the Securities Act may be enforced through Commission action or by private rights of action. */ Private suits are a large multiple of Commission enforcement actions.

Not all sales of securities require registration under the Securities Act. Certain kinds of securities **/ and certain

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*/ Private rights of action have been judicially implied under the general antifraud provisions of the securities laws. The ability of a purchaser of exempt securities to bring a private action against the seller of those securities under one of the Securities Act's express rights of action is limited in one regard. Section 12(2) of the Securities Act, which expressly creates a private right of action for false or misleading statements by a seller, includes an exemption for securities issued or guaranteed by such entities as federal and state governments and certain banks.

**/ These include federal and state government and municipal securities, certain bank securities and securities guaranteed by certain banks, commercial paper, and securities of issuers operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes.

transactions involving securities */ are exempt from the federal registration requirements. **/ Sales of those securities, however, remain subject to the general antifraud provisions of the Securities Act. The statute does not provide the Commission with authority to exempt particular offerings from the registration requirements.

Cost-Benefit Considerations of Registration

Generally, the costs of a registered underwritten public offering will be greater and the process may take longer than a non-registered best-efforts private placement of securities with institutional investors. However, these costs may be more than offset by the benefits of registration, including the possibility of a higher price for the securities. Registration permits a broad public distribution to a greater number and range of institutional and individual investors, and the creation of an active secondary market in the securities. Further, it is common in unregistered private placements for institutional investors to require similar and sometimes more information than that required in a registration statement, more stringent terms and a lower price, justified in part by the lack of liquidity (i.e., investors cannot subsequently sell unregistered securities on the open

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*/ These include intrastate offerings, private offerings and exchange offers of one security of an issuer for another security of the same issuer.

**/ Even though exempt from federal registration requirements, such offerings may be subject to the registration requirements of one or more states.

market). */ All other things being equal, illiquid securities may sell at a 10% or larger discount from the price of liquid securities. Such a discount would significantly exceed the greater cost of a registered offering. Also, compliance with the registration requirements facilitates comparative analysis of the securities offered with already publicly traded issues.

It is, therefore, desirable for the financial advisors and legal counsels to the agencies to analyze carefully the size and nature of each financing, the quality of the loans to be sold and current market conditions in order to determine whether a registered public offering, a non-registered private placement or a combination of both, is the most advantageous means of selling large whole loans or packaging and marketing a portfolio of loans.

Application of the Securities Act to Proposed Loan Sales

Two approaches under consideration are the sale of individual or packages of loans, and the sale of participations or interests in pooled loans, either through a grantor trust or a single-purpose finance corporation.

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*/ In addition, in private placements, institutional investors commonly require periodic reports sometimes containing different but more information than that required under the Securities Exchange Act of 1934, which is discussed below.

The direct sale of loans would not appear to involve the sale of a "security" as defined under the Securities Act, and would not be subject to any of its provisions. While the definition of security in the Act includes the terms "any note" and "evidence of indebtedness", in recent years the courts have begun to distinguish between loans for "investment" purposes and those for "commercial" purposes. */ No single test has evolved, but generally the courts focus on the context in which the loan is made. Loans by government agencies to facilitate the construction of college dormitories, or to assist rural communities with local projects, are likely to be treated as "commercial" rather than "investment" loans, and therefore, the loans would not be deemed "securities." **/ However, if the sales were

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*/ Although applying doctrines with different names, all courts addressing the issue have recognized that many forms of ordinary lending are not notes or evidences of indebtedness intended to be covered by the registration and antifraud provisions of the Securities Act. The most widely accepted of these doctrines is called the commercial-investment test. The tests in all courts appear to operate principally through application of illustration and analogy rather than definition. Consumer loans and home mortgages are frequently-used examples of debt outside the definition of securities. Bank borrowings, including debt incurred for business purposes, are similarly regarded unless the particular form of debt has sufficient characteristics ordinarily associated with securities sold to the public. Exchange National Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976).

**/ A question that the courts have not considered is whether the circumstances of any later sales of those loans to third parties could cause the later sales to be treated as sales of securities. The resolution of this issue, however, would not affect the analysis applicable to the original sale of loans by the agencies.

effected through a broad public distribution of interests in such loans, they would be subject to the securities laws.

In addition, interests or participations in pools of such loans, whether in the form of equity or debt, would constitute "securities" under the Securities Act. The sale of such interests or participations would require registration with the Commission unless an exemption applies. The status of the entity issuing the participation or interest as a grantor trust or a single-purpose finance corporation does not affect this conclusion.

Possible Exemptions from Registration

Preliminary discussions with representatives of the FmHA and the DOEd concerning their proposed sales have identified three possible statutory exemptions from registration under the Securities Act, those contained in Sections 3(a)(2), 3(a)(4) and 4(2). In addition, certain foreign offerings do not require registration.

Section 3(a)(2)

Section 3(a)(2) provides an exemption for any security "issued or guaranteed by the United States . . . or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States . . . ." This exemption would be available if the entity issuing the interests or participations was formed or sponsored by the federal government or the agency selling the loans, and there was recourse to the government

or agency, or if the federal government or agency guaranteed the interests or participations. Since OMB's guidelines provide that all sales must be made without future recourse to the federal government, it does not appear that this exemption would be available.

Section 3(a)(2) also exempts from registration any security guaranteed by "any national bank, or any banking institution organized under the laws of any State, Territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official." The Commission's staff has treated standby letters of credit as guarantees by a bank. Therefore, if the participations or interests in the loan pools were backed by such a bank letter of credit, the Section 3(a)(2) exemption would be available. */

However, in the event of a default on a bank guaranteed security, the bank might encounter financial difficulties in honoring its guarantee and be taken over by the Federal Deposit Insurance Corporation. The FDIC is funded by its member banks, but has ultimate recourse to the U.S. Treasury. Therefore, guarantees by FDIC member banks appear to be prohibited under the

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*/ It should be noted, however, that the Investment Company Act of 1940 discussed below does not contain a corresponding exemption from its registration requirements for companies holding securities backed by bank guarantees.

OMB guidelines. Guarantees by banks not insured by federal agencies may permit exemption from registration.

Section 3(a)(4)

Alternatively, it has been suggested that Section 3(a)(4) may permit exemption from registration, if a single-purpose corporation established to sell participations in the pooled loans were set up as a tax exempt corporation under Section 501(c)(3) of the Internal Revenue Code. Section 3(a)(4) exempts securities issued by "a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the earnings of which inures to the benefit of any person, private shareholder, or individual." The Commission's staff does not have details of a specific proposal at this time, but it appears that this approach would render the United States Government the beneficiary of the tax exempt corporation's charitable activities.

The staff has not previously considered the applicability of the Section 3(a)(4) exemption to instruments similar to the proposal discussed above. However, this exemption has been unavailable to securities of entities organized and operated for tax exempt purposes when there exists a single, substantial nonexempt purpose being served by an otherwise exempt issuer. The flow of the proceeds from the proposed loan sales to the

government would not appear to constitute a "charitable" purpose within the meaning heretofore given to this exemption. Accordingly, this exemption may not be available.

Section 4(2)

Section 4(2) also has been suggested as a possible exemption. Section 4(2) exempts "transactions by an issuer not involving any public offering." Whether a particular offer and sale constitutes a private placement involves issues of fact and law. The basic principle is that the exemption is available only for a limited offering to investors who have financial knowledge and experience. Whether an investor has such knowledge and experience depends, in part, on that investor's access to the same kind of information as would be included in a registration statement, and on the sophistication of the person. Generally, an offering will be exempt so long as the offerees have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the investment.

In 1982, the Commission adopted Rule 506 in order to provide some objective standards for the availability of the Section 4(2) exemption. Generally, an offering is exempt under Rule 506 if it meets the following tests:

1. Neither general advertising nor solicitation is permitted.

2. a. All of the purchasers are "accredited investors," */ or

   b. If there are non-accredited investors, the issuer furnishes all of the purchasers the same kind of information that registration would require.

3. The purchasers may not include more than 35 non-accredited investors.

4. A report on Form D must be filed with the Commission. Form D is an eight-page form which provides notification to the Commission of sales of securities pursuant to the Regulation D exemption.

A sale of interests or participations in government loans that would come within Section 4(2) or the safe harbor provided by Rule 506 would generally involve large denominations ($100,000 or more), institutional investors (banks, insurance companies, pension funds) and no general advertising. Sales would not be exempt if they involve large numbers of non-accredited investors, advertising or other public solicitation of potential investors.

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*/ Section 2(15) of the Securities Act and the Commission's related rules define the term "accredited investor" to include banks, insurance companies and private business development companies, certain employee benefit plans and tax-exempt organizations, and natural persons whose net worth or income indicates risk-bearing ability.

Foreign Sales

Interests or participations could also be sold without registration outside the United States to foreign investors. The Commission generally will not take action for failure to register such offerings. Because the registration requirements of the Securities Act are intended primarily to protect American investors, the Commission has found registration of securities of United States issuers distributed abroad to foreign nationals unnecessary as a policy matter so long as the offering is made in a manner designed to assure that the securities "come to rest" abroad.

Registration of Participations and Interests Under the Securities Act

If no exemption is available, registration under the Securities Act would be required. */ And even if an exemption is available, an issuer is not precluded from registering securities with the Commission if it wishes to do so. Although sales of pooled government agency loans would involve a new security, and the

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*/ If the security issued by the grantor trust or single-purpose finance corporation is a debt security, the issuer would have to comply with the Trust Indenture Act of 1939 in addition to the Securities Act. The purpose of the Trust Indenture Act is to provide for an independent trustee to protect and enforce the rights of the holders of the securities. The Trust Indenture Act requires the filing of a contract, the indenture, which specifies the duties of the trustee and sets forth standards to assure the independence of the trustee. Once the indenture is qualified at the time the registration statement becomes effective, the Commission has no enforcement powers under this statute.

agencies have not finalized their plans for selling their individual securities, the Commission's staff has had experience processing registration statements for products that may be similar to those proposed by the agencies. For approximately ten years, issuers have been filing registration statements relating to securities backed by portfolios of mortgages. In FY 1986, for example, registration statements for Collateralized Mortgage Obligations ("CMO's") totaled over $80 billion. In recent years registration statements securitizing other forms of debt obligations have been filed. */ Some of these registration statements are filed by the company that originates the mortgage or other asset included in the pool. More typically, however, the registration statement is filed by a sponsor, often an investment banker, that purchases the mortgages or other assets from the originator or in the open market and sells a separate security backed by the pooled assets to the public.

Where the entity issuing the security is a grantor trust selling pass-through equity certificates or mortgage-backed bonds, the registration statement is normally filed by the sponsor on behalf of the trust to be formed. If the issuing entity is a single-purpose corporation formed as a wholly-owned subsidiary of the sponsor, that corporation signs the registration statement.

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*/ Examples include securities backed by automobile receivables, credit card receivables and lease receivables.

In either case the sponsor would be liable for any materially false or misleading statements in the registration statement. Liability arises in the first case because the sponsor signs the registration statement, and in the second case because the sponsor is in control of the single-purpose corporation. */ In those cases where the security is sold to the public by the sponsor, the role of the originator **/ of the mortgages or other assets would end upon sale of the assets to the sponsor, and the originator ordinarily would not be liable under the securities laws for violations in connection with the sale of the security. However, the originator (i.e., agency) may of course be civilly liable to the sponsor for fraud or under any of the representations, warranties, or other terms and conditions that survive the sale to the sponsor.

Depending on how the sales are ultimately structured, the content of any registration statement for the sale of pooled government agency loans may be similar to the content of those filed in connection with other asset-backed securities. In the case of the sponsor signing the registration statement on

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*/ Section 15 of the Securities Act makes controlling persons of individuals or entities found liable under the Act jointly and severally liable for the controlled persons' actions.

**/ In the case of the pooled loan sales, the government agency would be the originator.

behalf of grantor trusts to be formed, the sponsor would be identified and information concerning its activities on behalf of the trust would be provided. Because an investor's interest would be limited to the assets placed in the trust, additional information about the sponsor/issuer, including its financial statements, would not be required. In the case of a single-purpose corporation, information about the corporation would be required. If the corporation was newly formed it would have only a limited organizational history, and the information required would not be extensive. The financial statements would be limited to a balance sheet showing the capital contributed at the time the corporation was formed. In either case because the trust or corporation would be responsible for future servicing of the pool of assets, complete disclosure of its duties and responsibilities for that function would be required.

The bulk of the disclosure in the registration statement would involve information concerning the loans used to collateralize the securities being offered. Assuming that (a) no individual loan is significant to the pool as a whole and (b) the pooled loans are relatively homogeneous in terms, payment schedule, etc., the following indicates the type of information that would be required. */

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*/ If the pooled loans are not homogeneous, then additional information would be required.

1. General terms of the contracts that create the loans, or the parameters of the loan terms, including, but not limited to:
   a. the terms of payment,
   b. the collateral,
   c. recourse, and
   d. obligor options.
2. Nature of any credit analyses prior to making the loans.
3. Delinquency and loss experience, by number of loans and dollar amount, for:
   a. the type of loans in the pool,
   b. loans meeting the criteria for inclusion in the pool, and
   c. loans transferred into the pool.
4. Criteria for selecting loans to be included in the pool.
5. Loans included in the pool (grouped in ranges, weighted averages, or both depending on characteristics and range of terms), by number of loans and dollar amount:
   a. date of origination, remaining life,
   b. interest rate,
   c. the number of loans, average size,
   d. geographic distribution,
   e. original amount and remaining balance, and

f. original amount of the loans as a percentage of the value of the collateral.

6. Perfected security interests in the collateral.

7. Prepayment experience.

8. Any loan documentation problems.

SECURITIES EXCHANGE ACT OF 1934

Issuers of participations and interests evidencing pooled loans may also be subject to the Securities Exchange Act of 1934. */ The primary effect of the Exchange Act is to require periodic disclosure pursuant to Sections 13(a) and 15(d) of that Act. **/

Issuers selling securities pursuant to a Securities Act registration statement are required under Section 15(d) of the Exchange Act to file such periodic reports as would be required under Section 13(a) for the fiscal year in which the registration statement became effective, and for each subsequent year if they have 300 or more holders of the registered securities at the start of the fiscal year. ***/

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*/ In addition, in private placements, institutional investors commonly require periodic reports sometimes containing different but more information than that required under the Securities Exchange Act of 1934.

**/ Section 13(a) requires issuers with a class of securities registered under Section 12 to file annual and other reports as prescribed by the Commission's rules.

***/ Issuers that have total assets of more than $5,000,000 and equity securities held by more than 500 persons at any

(Footnote Continued)

The periodic reporting requirements include a Form 10-K annual report disclosing the issuer's business, properties and financial condition. In the case of pooled asset vehicles, the report normally would include specific information with respect to the assets included in the pool, and other information similar to that required in the initial Securities Act registration statement.

In addition, Sections 15(d) and 13(a) require subject issuers to file interim quarterly reports on Form 10-Q. The principal content of Form 10-Q is unaudited quarterly financial information. Finally, from time to time issuers must also file reports on Form 8-K, generally within 15 days after the occurrence of certain reportable events. */

(Footnote Continued)

fiscal year end must register the class of securities under Section 12(g) of the Exchange Act. Registration under Section 12(g) would result in the issuer's being subject to additional provisions of the Exchange Act, including the Commission's proxy rules under Section 14, and the insider trading requirements adopted under Section 16. Section 16 requires reports of acquisitions and dispositions of equity securities held by officers, directors and holders of 10% or more of such securities, and imposes liability on the persons required to report for purchases and sales or sales and purchases made within a six-month period.

*/ Reportable events are changes in control, acquisition or disposition of material amounts of assets, bankruptcy or receivership, changes in accountants and resignations of directors. Financial statements are required for certain acquisitions or dispositions of assets.

Section 12(h) of the Exchange Act authorizes the Commission to exempt an issuer, in whole or in part, from its obligations under Section 13(a) to file periodic reports. In the case of trusts issuing mortgage pass-through certificates, the Commission's staff, acting pursuant to delegated authority, has granted some relief from the required reporting regulations. These issuers have been permitted to file abbreviated Form 10-K annual reports and to discontinue filing Form 10-Q reports. Instead, such issuers file monthly reports under cover of Form 8-K in which the trustees provide information concerning the assets held in trust. This procedure significantly reduces the cost of the periodic reporting. Similar treatment could be accorded issuers structured to offer pass-through securities backed by government agency loans.

INVESTMENT COMPANY ACT OF 1940

Congress enacted the Investment Company Act of 1940 to address abuses associated with companies whose assets consist primarily of securities. These abuses included the failure to provide adequate information to shareholders; the management of investment companies in the interest of persons other than their shareholders; the issuance of securities containing inequitable or discriminatory provisions; the undue concentration or inequitable distribution of control; the use of unsound or misleading methods of keeping accounts and computing earnings

and asset values; the change of the character or control of the business without shareholder consent; excessive borrowing and issuance of excessive amounts of senior securities, resulting in unduly speculative junior securities; and inadequate assets or reserves.

The Investment Company Act applies to issuers engaging primarily in the business of investing, reinvesting, owning, holding, or trading in securities. It excludes from its scope operating companies, and holding companies engaged in industrial operations through subsidiaries. The statute generally distinguishes between two types of registered investment companies -- the unit investment trust and the management company. A unit investment trust offers redeemable interests in a fixed portfolio of securities and does not have a board of directors or portfolio managers. Management companies offer interests in a managed portfolio of securities and usually have boards of directors. Management companies can be either open-end or closed-end. Only an open-end management company -- also called a "mutual fund" -- offers redeemable securities, giving the holder of the security the right to receive approximately a proportionate share of the issuer's current net assets upon presentation of the security to the issuer.

The Investment Company Act requires a non-exempt investment company to file a registration statement with the Commission.

The statute imposes substantive and rigorous restrictions on the structure, operations and activities of registered investment companies designed to prevent the abuses that led to its enactment. Examples of these restrictions include:

1. Transactions involving persons affiliated with the investment company or its investment adviser are generally prohibited, absent prior Commission authorization or compliance with conditions of Commission rules.
2. Pyramiding of capital structure resulting from issuing multiple classes of securities and speculative investment practices are prohibited or restricted.
3. Persons guilty of securities violations or barred from the securities business are prohibited from employment by, or providing services to, the investment company.
4. Various fiduciary duties are imposed on companies and persons managing investment companies.
5. Sales and distribution practices are restricted except as permitted by Commission rule.
6. Assets are subject to strict custodial requirements, and specific amounts of fidelity insurance must be maintained.
7. Periodic reports must be sent to shareholders and filed with the Commission.

8. Specified books and records must be maintained and are periodically inspected by the Commission's staff.

9. Advisory contracts must be approved by shareholders.

The Investment Company Act imposes civil and criminal liabilities for violations of its provisions. The Commission may obtain injunctive and administrative relief. The statute also includes an express private right of action for recovery of excessive advisory fees.

The Investment Company Act includes numerous exemptions from its requirements, mainly in the form of exceptions to the statutory definition of an investment company. */ In addition, the statute provides the Commission with exemptive authority.

Cost-Benefit Considerations of Registration

The costs of registration under the Investment Company Act are not significantly greater than the costs of registering under the Securities Act, since Commission rules permit issuers to file one registration statement under both statutes. The substantive regulations under the Investment Company Act may

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*/ Section 3(c) of the Investment Company Act expressly exempts from the definition of investment company thirteen types of entities that otherwise would be subject to the Act. Exempt entities include charitable, small loan, private investment, and sales finance companies, and companies holding real estate interests. These statutory exemptions are based on such considerations as the nature of the offeror, the number and nature of security holders, and characteristics of the securities issued.

entail some additional direct or indirect costs. However, these costs may be offset by the tax benefits associated with Investment Company Act registration. */ Under the Internal Revenue Code, most investment companies that register under the Investment Company Act can qualify as "regulated investment companies." These companies are not subject to separate federal corporate income tax. Distributions of dividends or interest received, and of capital gains realized, are subject only to federal tax payable by the company's shareholders, as if the shareholders held the investment company's portfolio securities directly. **/

Registration under the Investment Company Act would also facilitate compliance with the OMB guidelines governing the loan sales, which require that future interest payments on any loans of tax-exempt entities be subject to federal income tax. The Internal Revenue Code permits regulated investment companies to choose whether to distribute tax-exempt income to shareholders as tax-exempt dividends or as taxable dividends.

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*/ Depending on the manner in which the pooled loans are structured, exemptive relief from certain provisions of the Investment Company Act may be required in order to achieve registered investment company status.

**/ The Tax Reform Act of 1986 also created tax flow-through benefits for any entity that qualifies for treatment as a Real Estate Mortgage Investment Conduit ("REMIC"). In general, a REMIC is defined as an entity consisting substantially of a fixed pool of mortgages secured by interest in real property that issues multiple classes of securities to investors. Depending on the nature of the loans involved, these provisions may provide an alternative method for some loan sales to achieve favorable tax treatment.

Application of the Investment Company Act to Proposed Loan Sale Methods

Section 3(a)(1) of the Investment Company Act defines the term "investment company" to include any issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities, and Section 3(a)(3) defines investment company to include any issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."

The sale directly to the public of whole loans or packages of whole loans would not involve the creation of an investment company. Therefore, such sales would not be subject to the Investment Company Act.

The sale of debt or equity interests in a pool of government loans would result in the creation of an "investment company" as defined by the statute. */ Although the loans in which the entity

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*/ This is so whether the entity issuing the interests takes the form of a grantor trust or a single-purpose finance corporation. Since the vehicles have not yet been structured, it has not yet been determined whether any sales vehicles proposed by the FmHA or the DOEd that would register under the statute as investment companies would be classified as unit investment trusts or management companies.

would invest are not themselves "securities" for purposes of the Securities Act, courts have construed the term "securities" as used in the Investment Company Act to include such instruments. Therefore, the sale of interests or participations in a pool of loans would require compliance with the requirements of the Investment Company Act, unless a statutory exemption from the definition of investment company applies or exemptive relief from all or some of the statute's requirements is granted.

Possible Statutory Exemptions from the Investment Company Act

During preliminary discussions with representatives of the FmHA and the DOEd, the nature of the loans and the possible exemptions from the Investment Company Act have been discussed. Based on those discussions and the Commission staff's preliminary understanding of the loans to be sold, exemptions contained in Sections 2(b), 3(c)(1), 3(c)(5)(A), 3(c)(5)(C), and 3(c)(10) of the Investment Company Act appear to be most relevant.

Section 2(b)

Section 2(b) makes the statute inapplicable to "the United States, . . . or any agency, authority, or instrumentality . . . or any corporation which is wholly owned directly or indirectly by [the U.S.] . . . ." As noted, a similar exemption for government securities exists in the Securities Act. However, the Investment Company Act exemption is more limited.

Issues to be considered in determining the availability of this exemption are the existence of a guarantee by the government and the relationship of the issuer to the government. If any sales by the FmHA or the DOEd will be made by an entity independent of the government or any agency, and without recourse to the federal government, the Section 2(b) exemption would not appear to be available.

Section 3(c)(1)

Section 3(c)(1) is the counterpart to the private offering exemption in Section 4(2) of the Securities Act. Its purpose is to exclude privately held investment companies from the operation of the Act.

Section 3(c)(1) has two basic requirements: that the securities not be issued to more than 100 "beneficial owners," and that the issuer not make -- or presently propose to make -- a public offering of its securities. Important issues in analyzing the availability of this section include determining who is a beneficial owner; what constitutes a "public offering;" */ and what plans the issuer may have for future offerings. At least some loan sales could be structured to come within this exemption.

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*/ The private offering exemption under the Investment Company Act has been construed differently from that under the Securities Act. For example, compliance with Regulation D under the Securities Act would not necessarily satisfy the requirements under the Investment Company Act.

Sections 3(c)(5)(A) and 3(c)(5)(C)

The exemptions in Sections 3(c)(5)(A) and 3(c)(5)(C) are available to issuers that are not issuing "redeemable" securities and are "primarily engaged in" specified businesses. Section 3(c)(5)(A) concerns businesses involved in acquiring obligations representing part or all of the sales price of merchandise, insurance and services. The legislative history of Section 3(c)(5)(A) reveals that the provision was intended to encompass the business of buying or dealing in "automobile paper or refrigerator paper" or other "small loans." Therefore, it is unlikely to be available to issuers participating in the government loan sales program.

Section 3(c)(5)(C) concerns businesses involved in purchasing mortgages and other liens on or interests in real estate. The two issues important in determining the availability of Section 3(c)(5)(C) are the interpretation of the terms "redeemable securities" and "primarily engaged," which have been analyzed by the staff in a wide variety of situations. For example, "redeemable securities" include securities redeemable upon 30 days notice, or by a third party acting as agent for the issuer. Staff interpretations state that an issuer meets the "primarily engaged" requirement if at least 55% of its assets consist of mortgages, or liens on, or interests in real estate. The remaining 45% must consist primarily of real estate related investments.

Examples of interests in real estate include: fee interests, leaseholds, a note fully secured by a mortgage solely on real estate, and GNMA, FNMA or FHLMC certificates comprising an undivided interest in the entire pool of mortgages backing the certificates ("whole pools"). Examples of real estate related investments include GNMA, FNMA or FHLMC certificates comprising a proportionate interest in the entire pool of mortgages backing the certificates ("partial pools"), and a limited partnership primarily engaged in acquiring and owning interests in real estate. Because the underlying collateral supporting the government loan obligations to be sold has not yet been fully identified, it is not possible at this time to determine whether the Section 3(c)(5)(C) exemption would be available for government loan sales.

Section 3(c)(10)

Section 3(c)(10) is the counterpart to Section 3(a)(4) of the Securities Act. It provides an exemption for any not-for-profit company "organized and operated exclusively for religious, educational, benevolent, paternal, charitable, or reformatory purposes." During initial discussions with representatives of the DOEd, they suggested that a not-for-profit charitable corporation could be established as the issuer of the participation interests, with the government as the "beneficiary." It would not appear, however, that the flow of the proceeds from the proposed loan sales to the government would constitute a "charitable" purpose as envisioned under Section 3(c)(10).

Additionally, according to staff interpretations, the entity seeking the exemption must first obtain a letter ruling from the Internal Revenue Service that it qualifies for a tax exemption under Section 501(c)(3) of the Internal Revenue Code. The entity must maintain its tax exemot status, or its exemption under the Investment Company Act will lapse.

General Exemptive Authority Under The Investment Company Act

Finally, the Commission has authority, by order or rule, to grant exemptions from all or specific provisions of the Investment Company Act. Section 6(c) permits the Commission to exempt any person or transaction from any or all provisions of the Investment Company Act if the exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. */ The statute requires that the Commission consider all of the terms and circumstances of the offering when it determines whether to grant exemptive relief under Section 6(c). The Commission grants exemptions on a fact-specific basis. Exemptive orders often contain precise conditions to ensure that the requirements of Section 6(c) are met. For example, the Commission has

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*/ This provision was discussed during Senate consideration of the Reconciliation Act. Congressional Record S16972, (daily ed. Oct. 17, 1986) (statement of Senator Helms).

granted issuers of CMO's exemptions from all provisions of the Investment Company Act, in situations where the CMO's will be issued in compliance with the Securities Act, the substitution of mortgage collateral is limited in kind and amount to that specified in the original offering, the collateral is held by an independent trustee or custodian, the bonds have a high quality rating by an independent rating agency, and the issuer is audited annually.

V. CONCLUSION

The manner in which loan sales required by the Omnibus Budget Reconciliation Act are structured and consummated will determine whether the sales are governed by the federal securities laws. At this time, the agencies subject to the loan sale requirement have not determined what form the loan sales will take. The Commission's staff is prepared to work with the agencies to resolve questions as to how the securities laws would apply to specific proposals and what exemptions, if any, are needed or appropriate.

As indicated on pages 8-9 and 26-27, there may be price or other advantages in effecting loan sales through registered public offerings, rather than unregistered private placements or other exempt transactions, and in registering the loan pools as investment companies. It is, therefore, desirable for the financial advisors and legal counsels to the agencies to analyze

carefully the size and nature of each financing, the quality of the loans to be sold and current market conditions in order to determine the most advantageous means of selling large whole loans or packaging and marketing a portfolio of loans.

Chairman LAFALCE. Thank you very much, Mr. Fleischman. This probably has been the most exciting hearing that we have had in a long time. The subject matter, in other words, is extremely complex and difficult to comprehend unless you study it quite attentively. I am sorry that we could not have had the witnesses' statements earlier, so that we would have had more time to study the issue. We will try to do better on that in the future. I do want to give all of the members ample opportunity to ask questions of the panel.

But let me just first, without asking specific questions, ask you where do you think you are in basic agreement and where do you find yourselves in fundamental disagreement? From left to right, Mr. Wolf.

Mr. WOLF. Yes; first in terms of scorekeeping, there are different ways to do it, but that we should change the way that we scorekeep loans, I think that we all tend to agree. I think that was true in the hearing last week as well. The way that we scorekeep right now is not appropriate and there are ways to do it better.

Second, I guess, that from my standpoint, I think that we all tend to agree that credit management reform is needed, and some of the things that are being proposed are having some impact on improving credit management.

Where I think that we begin to differ is across the board loan sales versus a somewhat more judicious use of sales of some portfolios. We do have experience, as a government, in selling loan portfolios, and in some cases, it has worked out reasonably well. So I do not want to say that we should not do it, but we have got to be more careful in considering across the board sales.

Chairman LAFALCE. How do you answer Mr. Wright's point that we have got $250 billion, and we are only talking, at least in the initial proposal, about 1.8 percent of that, although the Reconciliation bill, which was congressionally initiated, increased it to 2.4 percent.

Is 1 or 2 percent of the total judicious, or because of the magnitude of the outstanding loans should it be something much, much smaller than that in order to truly be judicious, if, in fact, you are going to proceed at all?

Mr. WOLF. I guess that I would not look at it from the standpoint of a percentage of our total portfolio, because our total portfolio is such a real mixed bag. We have got all sorts of things in there.

Chairman LAFALCE. Very well.

Mr. WOLF. I do not think that $2 billion, or $3 billion or $4 billion done right is the wrong way to go at it. That is what we are

doing on the pilot program to sell existing loan portfolios. The pilot program is different from what is proposed for the market plan: That is to sell all new loans.

Now, there are some loan programs that are taken out, the CCC and a couple of foreign loan programs. But, basically, most of the versions of the market plan that we have seen requires that we will sell all of the portfolios.

Chairman LAFALCE. Most of the versions of what, Mr. Wolf?

Mr. WOLF. Excuse me.

Chairman LAFALCE. Most of the versions of what and by whom?

Mr. WOLF. The administration proposal on future credit reform including the revolving fund.

Chairman LAFALCE. All right.

Mr. WOLF. As opposed to the existing pilot, which is in the initial proposals and in the budget reconciliation, which is limited to parts of limited portfolios.

Chairman LAFALCE. Still going left to right, Mr. Fleischman. Areas of agreement and disagreement.

Mr. FLEISCHMAN. In all honesty, Mr. Chairman, the areas that you are addressing, pertaining to Federal budgeting, are beyond the ken, or at least the expertise, of the Securities and Exchange Commission. We are bystanders in this discussion.

Chairman LAFALCE. Right. But before we go to Mr. Gramlich, just one little question.

Are you familiar enough with REMIC's to discuss them?

Mr. FLEISCHMAN. I have members of the staff with me this morning, Mr. Chairman, who may be able to answer your questions.

Chairman LAFALCE. All right. I do not know whether it is within the purview of SEC's concern, but I am concerned that very inadequate attention was given to the subject or REMIC's. Not insofar as their tax treatments are concerned, but insofar as permitting Fannie Mae and potentially Freddie Mac to issue REMIC's directly, and the potential adverse effect that such direct issuance by a quasigovernment sponsored entity could have on, first, disintermediation, second, a level playing field for those who would like to engage in such a market in the private sector precluding them perhaps, and therefore creating a monopolistic situation, and third, a potential adverse impact on monetary policy.

To the extent to which SEC might have pondered or might ponder that, I would appreciate your written comments.

Mr. FLEISCHMAN. We will provide them, Mr. Chairman.

[The requested information follows:]

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

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APR 7 1987

Committee on Small Business

April 6, 1987

The Honorable John J. LaFalce, Chairman
Committee on Small Business
U.S. House of Representatives
Room 2361, Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman LaFalce:

At the Committee's hearings on March 10, 1987, concerning the securities laws aspects of federal government loan sales, you requested that I respond in writing to several questions you posed concerning Real Estate Management Investment Conduits (REMICs). This letter provides that response.

In your request, you expressed some uncertainty as to the SEC's jurisdiction over the matters covered in your questions. On this point, the issues you have raised do not directly come within the purview of the SEC's administration of the securities laws and are more appropriately within the province of the Treasury Department, the Office of Management and Budget (OMB), and the Department of Housing and Urban Development (HUD). However, in the process of considering the status of REMICs under the federal securities laws, we have looked at the issues you raised in your questions.

The Treasury, in mid-November of 1986, approved the plans of the Federal National Mortgage Association (Fannie Mae) to issue REMIC multi-class securities without any restrictions on that agency's activities in the market. However, such issuance must also be approved by HUD. HUD has yet to give the final approval on Fannie Mae's application to issue REMICs. HUD was scheduled to rule on the application in early March but on March 6 delayed its ruling for another 45 days. The Federal Home Loan Mortgage Corporation (Freddie Mac) has sought approval from the Federal Home Loan Bank Board (FHLBB) to issue REMICs, but FHLBB has not ruled on its application.

One of the reasons why the relevant government bodies have had to spend a considerable time studying the issues is the apprehension of some investment banks, who are concerned that Fannie Mae would have an unfair competitive advantage in issuing REMICs under its quasi-governmental status. That status confers government borrowing privileges and an exemption from the securities laws, among other things. The disintermediation issues that you mentioned at the March 10 hearing arise from the possibility that Fannie Mae could create retail-oriented REMICs

that would draw depositors away from, for example, the thrift industry. The extent to which these issues raise the concerns you mentioned at the hearing will have to be determined by the relevant government bodies that must approve the issuance of REMICs by Fannie Mae and Freddie Mac.

You also raised a concern focused on the need for a level playing field in this area. Some in the private sector believe that Fannie Mae's competitive edge could ultimately supplant private issuance of the multi-class REMIC vehicles. This concern has been expressed to HUD in letters from the Chairmen of the FHLBB and the Federal Deposit Insurance Corporation, and is thus before those charged with granting or denying Fannie Mae's application.

Your last question dealt with the potentially adverse impact of direct issuance of REMICs by Fannie Mae and possibly Freddie Mac on monetary policy. The SEC possesses no special expertise in this area, and I would suggest that you may wish to contact other agencies that do, such as Treasury, the Office of Management and Budget, the Council of Economic Advisers, and the Federal Reserve.

I hope that the above responds to the questions you raised at the hearing. Please do not hesitate to contact me if I can be of further assistance.

Sincerely,

Edward Fleischman,
Commissioner

Chairman LAFALCE. Thank you. Mr. Gramlich.

Mr. GRAMLICH. Yes; let me try and sort out the answer to your question, which is a complicated one. The basic policy question is that you have all of these loans and do you sell them or not? The CBO wants to take a relatively neutral position on that.

There are arguments for doing it, and there are arguments for not doing it. It really is a policy question. Where we take a hard line is that whatever you do, you have got to count the deficit right, for largely the reasons given by Congressman Atkins.

Moreover, it seems to me that the GAO, OMB, and CBO are in basic agreement that the way to count the budget deficit correctly is to put in every year the true subsidy of the transactions made. That is, to convert the credit transaction to a grant basis, and count that in the deficit.

Now, there are some second-order issues where we seem to have differences. There are at least three second-order issues, and there may be more. One is the question of what you do about counting old loans.

Our point on old loans is that whether you sell them or not, they should not, as part of this budget reform, be treated as deficit reduction. These were transactions made some time ago, and it is

inconsistent with the spirit of the proposal to treat them as deficit reduction, whether or not they are sold.

Chairman LAFALCE. Mr. Wright has just proffered to withdraw the administration's proposed budget which does, in fact, count them as deficit reduction. I do not know if he speaks for the administration or not on that, or that he speaks personally.

Mr. GRAMLICH. Well, I am speaking about an issue that until this morning was the administration plan. So that is our position. Now, there are two points in the GAO question. One is that some loans are sold with partial recourse with the Federal Government retaining some guarantee, and the question is what do you do about them?

As I understood the GAO position, it was that somehow, you would have the scorekeeper split them up, and the things that are sold without recourse to the Federal Government would count as deficit reduction; the others would not. In other words, you take partial loans and split them up.

Our position is that this is really a thicket, and it causes a lot of agony for the estimators, many of whom are in our building. If you just had the simple rule that loans must be sold without Federal guarantees, that would be cleaner, and would make the budget process a lot easier in the long run.

Of course, in some analytic sense, you could defend a different position on partial recourse. But we think that in terms of political management it would be liable to lead to major problems.

A final point is what to do about loans for which there is not a very good market. There is a notion that the Federal Government could really take a bath if it tried to sell these things. Now some of that seems a bit suspect, because we seem to be gaining——

Chairman LAFALCE. The answer is that you just do not sell those.

Mr. GRAMLICH. You just do not sell them. And at that point, you would have to get into estimating the true subsidy value. I think that both OMB and CBO agree on that. They both agree that it is liable to be a very difficult problem. I guess the intent of all of these proposals is to confine the difficulty just to that issue, which is an intrinsic one. Because these loans have not been sold in the past, so markets will be developing for them.

Those are the three second-order issues on which there are shades of difference, but, basically, everybody seems to be in agreement on the broad reform.

Chairman LAFALCE. Thank you. To finish and round it off, Mr. Wright, areas of agreement and areas of disagreement.

Mr. WRIGHT. Mr. Chairman, I believe that there is quite a bit of agreement, as you have heard, and let me just make some brief comments. First of all, I totally agree with Mr. Wolf when he says that the total loan portfolio should not be sold as part of credit reform, which is the reason that we propose that it not be.

There is going to be approximately $32 billion in new direct lending proposed for next year. We propose to have one-eighth of that, $4 billion, in credit reform. So we are in complete agreement there.

We took out all of the CCC commodity loans. We took out all of the defaulted guaranteed loans, of course. We took out the disbursements from prior year obligations. That left us with $11 billion of that $32 billion. Then we took out the international loans

and many of the others that we thought were extremely politically sensitive or more closely to grants. That left us with four. Of the $176 billion in guarantees, we proposed to reinsure only $8 billion next year. So we totally agree with Mr. Wolf.

Chairman LAFALCE. Did you want to rejoin, Mr. Wolf?

Mr. WOLF. No; not particularly to rejoin. That is not a schedule that we have seen at this point, and we have looked at some of them.

Chairman LAFALCE. Is that in your testimony, Joe?

Mr. WRIGHT. That is not in my testimony. It is implicit in the budget that we proposed in January of this year.

Mr. WOLF. I do not think that there is a big inconsistency between what he is saying and what we are saying.

Chairman LAFALCE. I would agree with that.

Mr. WRIGHT. On the partial recourse point that was brought up, if you remove nonrecourse, you are going to get a lower discount. You are going to get more for the loan sale being proposed. So, we have never disagreed with that, except for one thing. If you are talking about credit management, like I was talking about before, if you put it in a partial recourse, you may get that loan back. If you have the potential of getting that loan back, you have got to maintain the staffing, and you have got to maintain the capabilities to collect against it in the future, and it is a future liability to the Federal Government. So, that is a tradeoff between getting more dollars up front versus a liability downstream, but more importantly, having to maintain the credit management capability. And that is what we have tried to avoid.

As for deficit reduction, Mr. Chairman, as you know, I cannot commit for the President as backing off of his proposal. That would be a career decision on my part. [Laughter.]

Mr. WRIGHT. And the President's budget is up on the Hill and it does meet the $108 billion by our scorekeeping. And if the Congress in its wisdom should decide that this is not a good deficit reduction vehicle, then we would be more than happy to work with you on whatever options you may come up with. But as I said, since we are directed toward credit management——

Chairman LAFALCE. Would you be willing to switch from deficit reduction in the budget proposal to strictly credit management, so long as we would also cut Social Security as a substitute?

Mr. WRIGHT. No; I do not think that is a good idea either.

Chairman LAFALCE. Okay.

Mr. WRIGHT. The point that I was trying to make is the emphasis on the credit management. And where I have heard before from some of the outside economists that we take it out of Gramm-Rudman's schedule and we apply it against the debt, that is something to talk about.

I think that the rest of the disagreement that we may have is scorekeeping. And I am not so sure that we want to use up the good time of this committee to go over scorekeeping issues.

Chairman LAFALCE. No; good. All right, thanks. I have a number of other questions, but my time has expired. Mr. Ireland.

Mr. IRELAND. Thank you, Mr. Chairman. Actually, I will say that you are to be credited with a very large accomplishment. You apparently have presided over bringing all of these various bodies to

agreement that asset sales do not affect the budget. That is a remarkable achievement for a little over an hour here.

Chairman LAFALCE. The only problem is that there might be some disagreement on that side of the table as to your conclusion. [Laughter.]

Mr. IRELAND. Right. But we are getting close. I would add a comment though as we talk about scorekeeping and such from a policy point of view. Again, as we have said, we are not here to answer exactly how scorekeeping is arrived at, but it probably should be pointed out that a good many people downtown and elsewhere on the Hill really do not want to know what the score is.

I favor, very strongly, getting a better handle on knowing just what kind of subsidies this Government is handing out. That is the guts of our problem with an awful lot of people who do not want the whole light of day put on just where those subsidies are going.

Having said that, I thought maybe as a followup to the chairman's question that maybe Mr. Wolf and Mr. Gramlich could respond to what Mr. Wright said when he mentioned, that it would be all right to use this asset sale as a direct charge to the debt rather than running it through the annual deficit. I think that was right.

Mr. GRAMLICH. It seems correct to me. I take it that the idea is that you have some old loan that is in the Government's portfolio and that this is then sold for money. Now we would say that since it is an old loan, it is not a new subsidy, it is simply an asset transaction and should not count in the deficit for that year.

So that would be independent of the deficit, but the Government would have cash received from selling the loan, and therefore could use that to pay off the national debt. I take it that is what Mr. Wright meant, and that seems correct to me.

Mr. WRIGHT. Well, this was proposed, Mr. Ireland, by some economists who came in last month and said that they would not have any problem if it were applied to the permanent debt versus the ongoing deficit.

The only thing that I thought was unusual about that, which is why the administration went on ahead and proposed it as an offset against the current deficit, is why would you include the sale of Conrail—albeit maybe three times—or any other Federal asset as a deficit offset?

A loan asset is an asset that is on the balance sheet of the United States Government. And if you are going to make a decision that a loan asset should not be an offset against the deficit, then you ought to revisit the decision for any other kind of asset. Loan assets should not be isolated just by themselves.

Chairman LAFALCE. It makes good sense, does it not?

Mr. WRIGHT. But that is one of the reasons why we took a look at it and said the way that we felt that it should be handled was that it does reduce the current deficit. However, it does not, and we recognize this, reduce what we would call the ongoing, built-in deficit of the Federal Government.

Mr. WOLF. I guess that there were about six things that were said there that I could comment on. First of all, you are right, Joe, any asset that we sell, if we sell our house to pay our mortgage, we should not feel real warm and happy about it. We should not be

counting those as reducing our deficit, whether it is Conrail, or loans or anything else.

Joe mentioned that we have all of these assets on our balance sheet. In fact, that is one of the things that we have been complaining about for some time. We do not have a balance sheet. Therefore, we do not keep track of this stuff very well.

Mr. IRELAND. Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you. Mr. Hayes.

Mr. HAYES. Thank you, Mr. Chairman. I am in complete agreement with your statement of the complexities of the whole line of discussion here. I have been trying to reduce it to lay terms to find out how I can apply this kind of discussion to my chief concern; that many of my constituents are unemployed and looking for work.

The source of employment before they were laid off was what we categorize as small business, some of whom are struggling now because of Chapter 11 or bankruptcies, which raises in my mind the big question of what is the percentage, if we have any figures to indicate the percentage, of the Direct Loan and Guaranteed Loan Program that are in default; do we have any figures to indicate that?

And then, the companion question that goes with that is do we have any trend as to who are the purchasers of these loans that we sell. Because I heard mention of the fact that investment companies purchase many of these loans that we sell, and they are almost insulated against losses. So I would just like to know an answer to those two questions.

We say that these portfolios do not reduce the deficit and that it does not improve the cash-flow to any measurable extent, as I understood it. I may have understood it wrong now. But we have got a huge, huge deficit.

Mr. WRIGHT. Mr. Hayes, if I can take the question just to start with. Can we redefine for purposes of the conversation what the deficit is. Really, how we look upon it is how much the Treasury has to go to the private markets to borrow to finance Federal operations when you do sell an asset that does reduce the amount that the Treasury has to go and borrow in order to finance. That is the main impact that we see that the deficit has within the economy. So asset sales do reduce that for that 1 year.

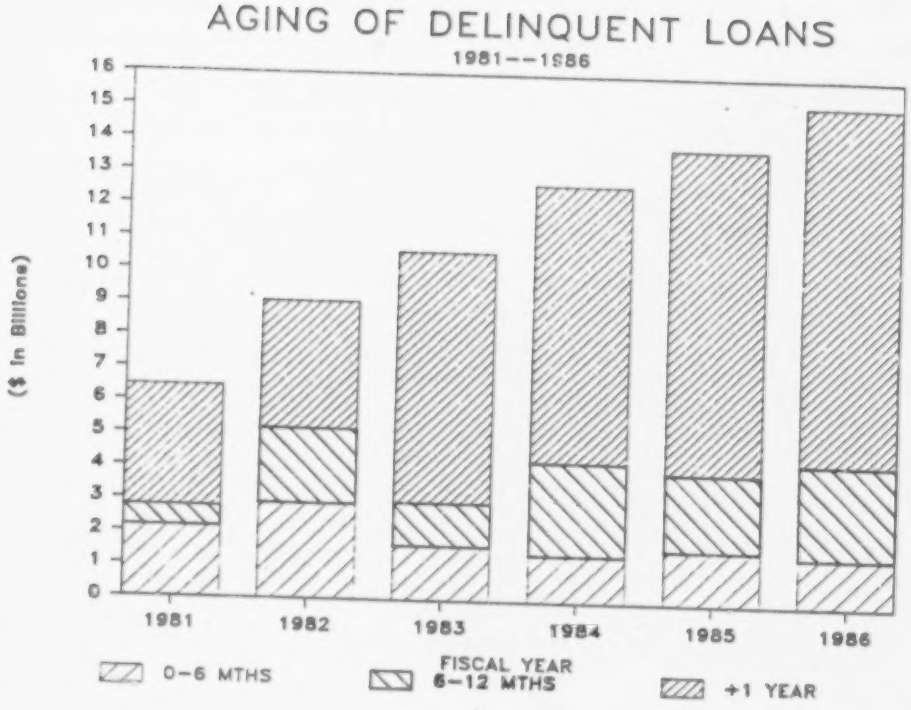
Now the only other thing that I would add to the conversation is, as Mr. Wolf said, you would not sell your house to pay your mortgage. In private corporations when they get into deep, serious trouble, yes; they do sell off divisions, and yes; they do sell off assets in order to make themselves healthier. And that is looked upon, normally by an increase in their stock price, as the right management decision.

I have heard many things that this is not the right thing to do. I would question whether or not this might be one of the best ways to go during this period of time, and take an asset that does not have the social consequences or the economic consequences of some of our real estate, for example, or some of our Government agencies, or whatever it is. That is a much easier way to do it.

Now in the SBA loans that you are talking about, the total delinquent SBA loans, and I believe that this is on a principal basis, in fiscal 1986 was $2.3 billion in delinquency.

The alarming thing about this number—and by the way, Mr. Chairman, I would be happy to provide this for the record, as I think that it might be interesting for you to see.

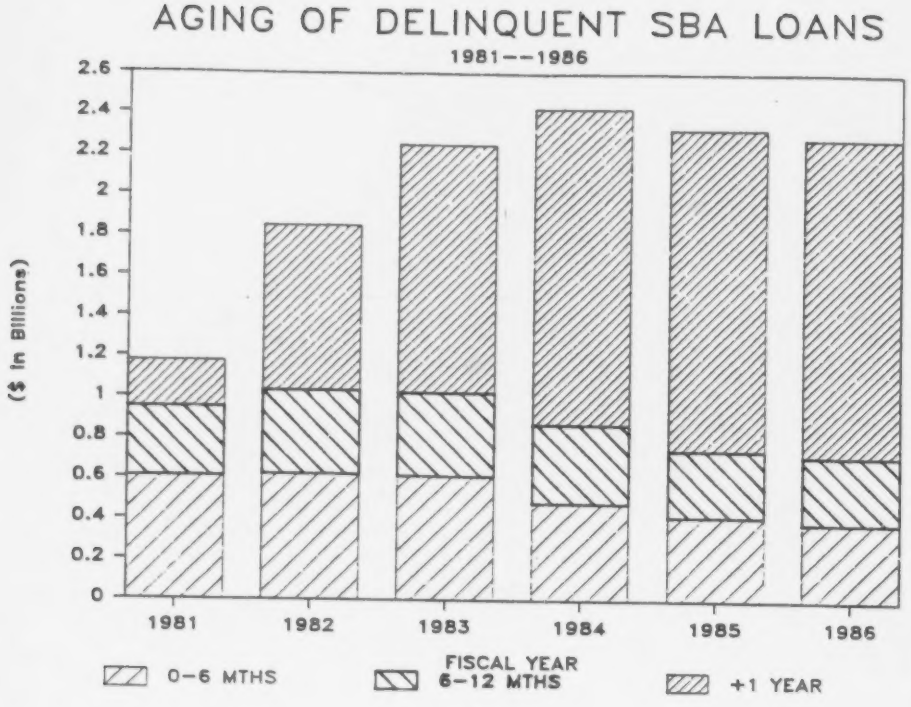
[The information referred to follows:]



	1981	1982	1983	1984	1985	1986
TOTAL RECEIVABLES	241.5	273.1	293.9	318.0	345.8	363.9

	1981	1982	1983	1984	1985	1986
TOTAL LOANS RECEIVABLE	193.1	216.0	229.1	232.0	254.8	251.6
AGING OF DELINQUENT LOANS						
0-6 MONTHS	2.2	2.9	1.7	1.4	1.6	1.5
6-12 MONTHS	0.6	2.3	1.3	2.8	2.3	2.8
OVER 1 YEAR	3.7	3.9	7.6	8.4	9.9	10.9
TOTAL DELINQUENT LOANS	6.5	9.1	10.6	12.7	13.8	15.2

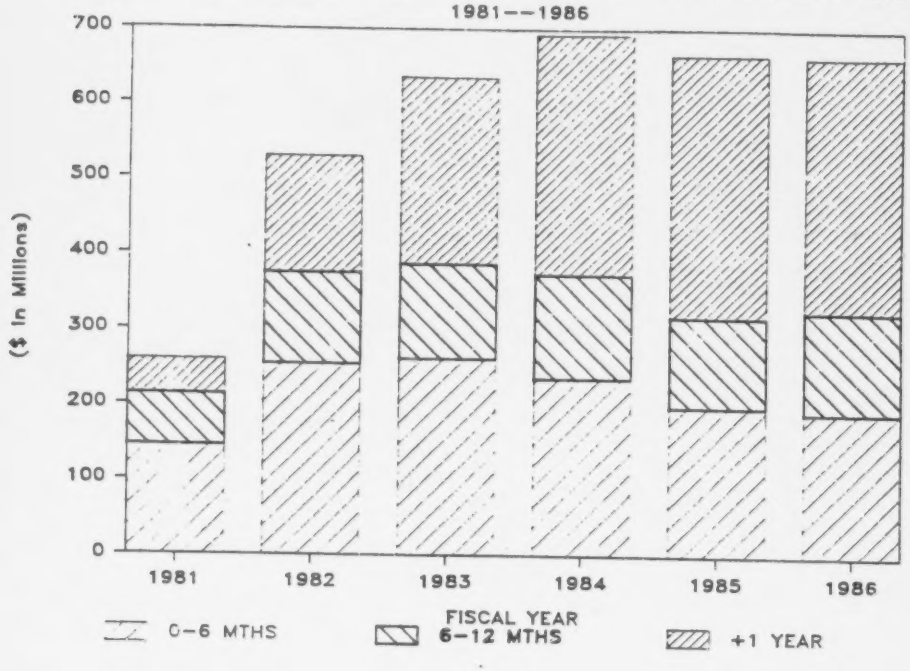
($ IN BILLIONS)



SBA	1981	1982	1983	1984	1985	1986
TOTAL LOANS RECEIVABLE	9,147	9,169	8,815	8,299	7,777	7,265
AGING OF DELINQUENT LOANS						
0-6 MONTHS	611	619	612	480	417	385
6-12 MONTHS	341	412	410	389	327	331
OVER 1 YEAR	227	813	1,225	1,560	1,583	1,562
TOTAL DELINQUENT LOANS	1,179	1,844	2,247	2,429	2,327	2,278

($ in millions)

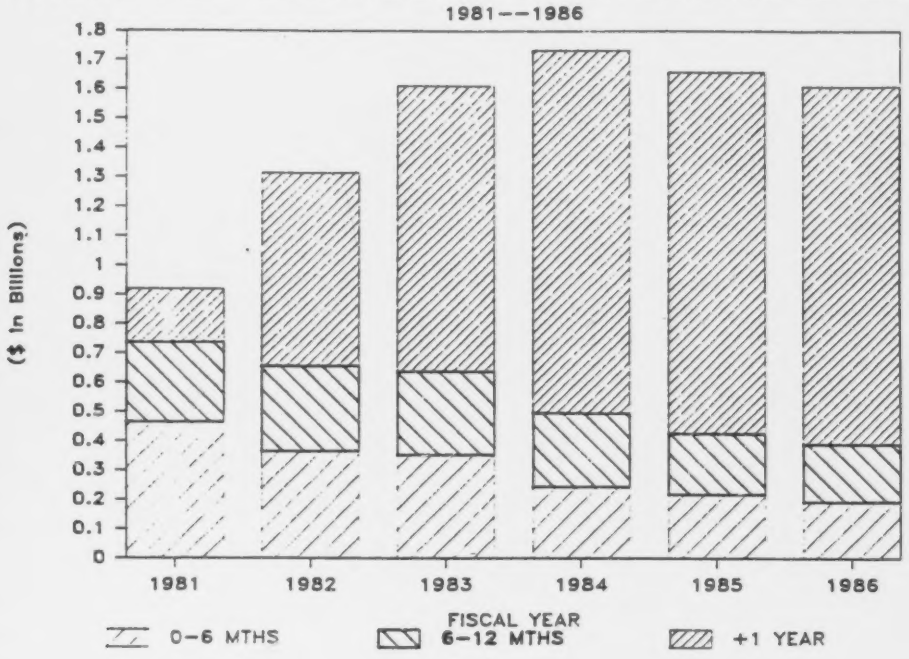
AGING OF DELINQUENT SBA DISASTER LOANS



	1981	1982	1983	1984	1985	1986
TOTAL LOANS RECEIVABLE	6,444	6,073	5,496	4,960	4,557	4,222
AGING OF DELINQUENT LOANS						
0-6 MONTHS	146	254	261	235	198	191
6-12 MONTHS	68	121	126	138	120	135
OVER 1 YEAR	46	155	249	320	348	338
TOTAL DELINQUENT LOANS	260	530	636	693	666	664

($ IN MILLIONS)

AGING OF DELINQUENT SBA BUSINESS LOANS



	1981	1982	1983	1984	1985	1986
TOTAL LOANS RECEIVABLE * **	2,703	3,096	3,320	3,340	3,220	3,007
AGING OF DELINQUENT LOANS						
0-6 MONTHS	465	365	352	245	218	193
6-12 MONTHS	273	291	284	251	207	196
OVER 1 YEAR	182	659	977	1,240	1,235	1,224
TOTAL DELINQUENT LOANS	920	1,315	1,613	1,736	1,660	1,613

($ in millions)

* Does not include SBIC & Section 503 loans as shown on Special Analysis F.

LOAN ASSET SALES PORTFOLIO FACT SHEET
as of September 30, 1986

Business and Investment Loan Fund

- Total loan receivables peaked in FY 84. They have declined slightly each year since FY 84.
- Delinquencies have doubled since 1981.
- The percentage of delinquent receivables has remained high over the five year period. Since new receivables have been declining since FY 84 the proportion of delinquent receivables has risen steadily.
- SBA has not collected or written off the old delinquencies (due over 360 days) since the percentage of total delinquencies due in over 360 days exceeds 75 % at the end of FY 86.

Disaster Loans

- Total receivables have steadily declined from FY 81 to the present time.
- Total delinquencies grew annually until FY 1984 and then declined through FY 1986.
- Although the percentage of delinquencies is relatively modest, it has grown consistently over the five year period.
- The rate of increase in delinquencies due over 360 days has decreased over the period reflecting the relative stability of the actual delinquencies.
- The percentage of delinquencies due over 360 days has continued to rise faster than the growth in the delinquencies, indicating that SBA has again not collected or written off the old debt in the portfolio.

LOAN ASSET SALES PORTFOLIO FACT SHEET
as of September 30, 1986
(dollars in millions)

AGENCY : SBA
PROGRAM NAME : SBA BUSINESS AND INVESTMENT LOAN FUND
PROGRAM DESCRIPTION : Includes loans under the Business loan and investment fund
TYPICAL BORROWERS : Individuals, partnerships and corporations
INTEREST RATE : 11.0%
LOAN TERM : 14 Years
FINANCIAL ADVISOR : RFP advertised

MEET SEC STANDARDS FOR REGISTRATION FOR FY 1987 : Uncertain

HOW DELINQUENT DEBT HANDLED

Report to Credit Bureau	: YES	
Pre-screening	: YES	
Collection agencies	: YES	
Refund Offset	: n/a	(Business accounts excluded)
Salary Offset	: YES	
Litigation	: YES	
ESTIMATED SUBSIDY RATE	: 20.8 %	

OF LOAN ACCOUNTS EOFY 86 :

	BUSINESS AND INVESTMENT AND LOAN FUND ONLY						:	INCLUDES SBIC AND SEC 503 DEVELOPMENT		
	FY 81	FY 82	FY 83	FY 84	FY 85	FY 86	:	FY 87	FY 88	FY 89
PROPOSED SALE BY FISCAL YEAR							:	0	1,000	1,000
RECEIVABLES	2,703	3,096	3,320	3,340	3,220	3,007	:	4,950	4,769	
DELINQUENCIES	919	1,315	1,612	1,736	1,661	1,613	:			
% OF RECEIVABLES DELINQUENT	34.00	42.48	48.56	51.99	51.57	53.65	:			
% OF DELINQUENCIES ½ 360 DAYS	19.79	50.09	60.58	71.43	74.39	75.87	:			

March 9, 1987

LOAN ASSET SALES PORTFOLIO FACT SHEET
as of September 30, 1986
(dollars in millions)

AGENCY	: SBA
PROGRAM NAME	: SBA DISASTER LOANS
PROGRAM DESCRIPTION	: Below market loans and guarantees to rehabilitate homes and business property damaged by natural disasters
TYPICAL BORROWERS	: Individuals, businesses and non-profits
INTEREST RATE	: 3.0-8.0%
LOAN TERM	: 30 Years
FINANCIAL ADVISOR	: RFP advertised

MEET SEC STANDARDS FOR REGISTRATION FOR FY 1987 : Uncertain

HOW DELINQUENT DEBT HANDLED

Report to Credit Bureau	: YES
Pre-screening	: YES
Collection agencies	: YES
Refund Offset	: YES
Salary Offset	: YES
Litigation	: YES
ESTIMATED SUBSIDY RATE	: 44.4 %
# OF LOAN ACCOUNTS EOFY 86	: 207,005

PROPOSED SALE BY FISCAL YEAR	FY 81	FY 82	FY 83	FY 84	FY 85	FY 86	FY 87	FY 88	FY 89
RECEIVABLES	6,444	6,073	5,496	4,960	4,557	4,222	4,222	3,283	670
DELINQUENCIES	260	530	635	693	666	665	670	670	670
% OF RECEIVABLES DELINQUENT	4.03	8.73	11.56	13.98	14.62	15.74			
% OF DELINQUENCIES ½ 360 DAYS	17.53	29.17	39.18	46.18	52.20	50.86			

March 9, 1987

Chairman LAFALCE. Out of a total universe of what?

Mr. WRIGHT. $7.265 billion. That is total loans receivable at the SBA at the end of last year. Now the interesting thing about this is the aging of the delinquent loans of over 1 year, which as you know is seriously delinquent. At a bank, if you have it over 6 months, you normally write it off. It has gone up from $227 million in 1981 to $1.562 billion in 1986. So it is a serious problem.

Mr. HAYES. These are delinquents, not defaults?

Mr. WRIGHT. Yes, sir; but I question this because in the private sector you would have written those off. In many cases in the business loan portfolio, one of the reasons why you find that discount rate is so high in the proposed sale is that many of those—I think about half of them—are guaranteed loans that have defaulted and have been sent back to the Government that are then scored as a direct loan. So, they have gone through an intensive collection process already. In effect, Mr. Chairman, they had little to no value.

Now you might question, and again, I go back to credit management, why do we put them on our files, why do we assign collectors to them, and why do we keep maintaining them as an asset? They are not.

Chairman LAFALCE. Are there any further questions?

Mr. HAYES. Well, I just got a little note saying that my time is out.

Chairman LAFALCE. Thank you. Mr. McMillan.

Mr. MCMILLAN. I am intrigued by the idea that we have gotten on, because I think that it is getting on target when you are treating sale of assets as a potential reduction in the long-term debt rather than not a deficit reduction item.

Has anyone really taken a look at that in terms of range of possibilities and in terms of the magnitude of assets including loans that could be sold, and the impact that that would have on the current operating budget, not in terms of the proceeds of the sale in reducing the deficit, but the reduction in interest costs on the national debt offset by whatever revenue is foregone on those assets sold. That, it would seem to be, would get closer to the truth of the matter in terms of the real impact on current operation.

In looking at the issue of sale of assets, OMB, have you in effect surveyed the whole universe, so to speak, of possible options, so that an intelligent look could be taken as to what would happen if under some planned program certain assets and loans were sold off, and what would the real impact on the budget be over time, because I think that gets closer to the truth of the matter in terms of what we are trying to determine here?

Mr. WRIGHT. We have taken a look. Now when you ask if we looked at all of it and all of the alternatives, we really have not. Because, in part, of the information that we have at OMB. I have to say that what most of the large agencies have on their portfolios is by no means perfect enough to do the type of analysis that you are talking about.

We do have an interagency group that did come up with their proposals on the loan asset sales and the whole credit reform. It has been working for over a year right now to do what you are

talking about. And our information is much better, but it is not something that would answer your question perfectly.

We proposed these sales as a reduction against the current deficit, because it is traditionally the way we, the executive branch, and the Congress have been handling the sales of assets for as long as I can recall.

It is also one in which I can see some validity in and while it does not affect the structural long-term deficit, it does affect the borrowing that Treasury has to make. So, therefore, I think that there is a credible reason for offsetting sales revenue against this year's deficit.

In the proposal that we came up with on the credit reform, we do have a schedule which will be included in what will be coming up to the Congress of the loan asset sales by year to the year 1992. And those numbers on face value are $3.6 billion in fiscal 1988; $2.9 billion in fiscal 1989; $2.3 billion in fiscal 1990; $1.9 billion in fiscal 1991; and $1.5 billion in fiscal 1992.

Mr. McMillan. Those latter numbers were what now?

Mr. Wright. That is the face value of loan assets sold, based on the January budget.

Mr. McMillan. That is assuming the proceeds from the assets as deficit reduction. I think that the interesting way to do it, and it may be too late this year, but in order for us, either in respect to SBA loans and looking at it with respect to the entire budget, to really do justice to this would be to look at all potential assets or loan asset sales, and the impact that it would have if the requirement were there that the proceeds be used to retire long-term debt, and then what the net effects would be on the budget.

Then I think we would have a perspective. We then would be able to make the kind of judgment that Mr. Wolf raised. We do not want to sell the house to pay off the mortgage, if we need a house. But we may be able to live in a smaller house or we may not need the house. In the case of Conrail, maybe someone else needs it more than we do.

Mr. Gramlich. Congressman, if I may just comment on that. You are quite right that if you try to price this out in a true sense you have to keep these sales out of the deficit, and just treat them as conversions of the outstanding debt which you can pay off by selling old assets.

Now the next question is whether that is a good idea. On the one hand, you do not have the interest burden from the outstanding debt. On the other hand, these things do entail future repayments. I mean that loans will be repaid, and there will be interest coming in and so forth.

And the way that economists would normally think about this is that you have a package, this old loan, and when it is sold the market will discount all of the future payments coming in from the loan at the going interest rate, so in that respect there will not be any saving.

If, as Mr. Wright is saying, there are some new efficiencies in managing the credit or something like that, then you may get savings. But you are not going to get savings just from a lower interest burden, because you will also have less repayments coming in, and they are all discounted by the market.

Mr. McMILLAN. I understand that, particularly in loan situations, but my remarks were directed not just at that marginal situation, but the sale of maybe some substantial assets for which there is no revenue in the present budget.

Mr. GRAMLICH. Well, if there is no revenue, I wonder how much you can sell them for.

Mr. McMILLAN. Well, I mean we debate Conrail; are we getting any revenue from Conrail?

Mr. GRAMLICH. We are getting a little bit. If we are not, we are not going to sell it for anything.

Mr. WRIGHT. We are getting revenue from Conrail. The other thing, Federal agencies sell a great deal of assets every single year as part of their operations that are included as offsetting receipts.

Let me give you an example—old military equipment. Another example—the Customs Service sells whatever they may pick up at the border and all of the rest of it. This is the normal way of business.

If you want to carry this to the extreme, then we probably ought to take a look at whatever assets the Government sells right now and applies as an offset against outlays to reduce the deficit. I do not see much difference between a loan asset sale and selling off old military equipment that we have paid for that is on our books.

Mr. McMILLAN. Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you. Mr. DeFazio.

Mr. DEFAZIO. Just to follow up on that line of logic, Mr. Wright.

What is the future earnings potential of that old military equipment versus the future earnings potential of these loan assets; there is no future earnings potential with that military equipment?

Mr. WRIGHT. Well, there is no future earnings potential, but I would say again that it is treated as an offset against present expenditures. And in many cases, what you are doing is you are selling off old equipment to replace with newer types of equipment. And I have questioned many times whether or not that whole policy is looked upon not only within the military but across the board as carefully as they should be. In the case of loan assets, you have an offset against an expense versus a revenue stream. There is a difference. But on the other hand, we look at it the way that Congress looks upon it—how much do you have to appropriate?

Mr. DEFAZIO. I would agree that we should review that and perhaps we should not be purchasing all the new equipment, but that is for another committee. On page 10 of your testimony—we were discussing that this is not a deficit reduction. That that is not the primary objective of the pilot program. I guess that I would like to get into that a little bit. There are three objectives. Improving credit management, achieving administrative savings, and identifying subsidies.

At the scale that you are recommending in this pilot program, how large will the administrative savings be, considering the fact that, by the figures you gave us, a very small percentage of the total portfolio will be sold, as I would assume that you are going to have to keep most of the administrative structure in place at least during the pilot program?

Mr. WRIGHT. I would imagine that you would have to, Congressman. You might get some savings in the first year or the second

year, but I doubt if it will be much beyond what you would call putting an asterisk up against it.

I think that it would be irresponsible for an agency to go and substantially pull back their credit management activities, if they still have 80 percent of the portfolio out there that they have to manage. They will get some savings, but it will not be significant.

Mr. DEFAZIO. Well, that gets to the second point, improving credit management.

If we can sell these loans in the private sector and they can be purchased and profitably managed, is it impossible for the Government to do that. You are saying that the credit management has not been up to the standards of the private sector.

Could you not have administrative overhaul or changes within the agency that would bring those standards up, so we could have the best of both worlds. We could maintain the assets, improve the future revenue stream, and not sell these assets presently.

Mr. WRIGHT. You could help the situation by improving the management. Now I am not so sure that that is the best resource to put Federal dollars into. The credit policy making and the credit disbursement, yes; I think that is part of our job. The management of it which is done so well in the private sector, I am not so sure that it is the best use of Federal dollars and personnel.

But there have already been substantial steps taken. When the Debt Collection Act was passed in 1982 by the Congress, that allowed us, for the first time, to be able to go out, for example, and prescreen new loans. That is being done. That allowed us, for the first time, to go and report delinquent borrowers to the credit bureaus to affect their credit ratings, which as you know is one of the biggest impacts that you can have, in order to cause repayment. That has been done.

Since then, in 1984 Congress passed other legislation which allowed us to go ahead and start the Internal Revenue Service Offset Program on Refunds. That has been very effective. So there have been changes that I think have improved the matter substantially.

However, you do not have the incentive structure within the Federal Government, even if you were to decide that the proper resources of Federal expenditures and people is just to manage old portfolios. Even if you decide that, you cannot pay them large incentives for collection performance within the way that we handle our civil service.

Therefore, I think that it would be extremely difficult. Also, I question whether or not we would want to go through the investment of all of the equipment and the information systems which basically duplicates what the private sector already does to just be able to go on ahead and manage those in the Federal Government. That is the question.

Mr. DEFAZIO. We are in this for the long term, and I adhere to the point that short-term sale may give us a blip down a bit in the deficit now, but in the future I am going to have larger problems to deal with, and I intend to be here awhile.

You say corporations do this all of the time. I can give you some corporations that have gotten into a lot of trouble by selling future revenue streams at fire sale prices in order to get out of a cash difficulty in 1 year.

So, I think that your arguments would lead us to believe that we could have the best of both possible worlds by improving further the credit collection, improving further our future revenue stream, and in fact helping to offset future deficits more while maintaining the program within the Government.

Mr. WRIGHT. I think that there is a happy medium. I do not believe, based upon past performance for the last 30 years, that maintaining it in the Government is the way to go. And I would also like to respond again that this is not merely a way to reduce the deficit. If it were, there would have been full recourse and full tax passthrough.

Mr. DEFAZIO. Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Hiler.

Mr. HILER. I thank the chairman.

Mr. Wright, you mentioned a couple of figures. I think in 1981 there were $227 million worth of SBA direct loans and guarantees that were being scored as delinquent direct loans, the definition of delinquent being over a year old. And that in 1986, that that figure had climbed to $1.562 billion.

Is that what you said?

Mr. WRIGHT. Yes, sir; in 1981, the total loan receivable for the SBA was $9.147 billion. The delinquent amount was $1.179, of which $227 million was over 1 year. In 1986, the end of 1986, the total loan receivable was $7.265 billion. The total delinquent portion of that was $2.278 billion. And over 1 year, it was $1.562 billion.

Mr. HILER. Would it be possible to get from you—maybe going back 10 years, maybe going back 6 years, but 10 years would be great—the amount of SBA direct and guaranteed loans that were put out into the marketplace and a history of the loans in that particular year.

In other words, in 1986, the $1.562 in delinquency is interesting, but what would be more interesting is, do those $1.562 billion in direct and guarantees emanate from pre-1981, or post-1981, or post-1983, to know whether the loans, both direct and guarantees, that we have been extending in the last few years, whether we have made any better track record at trying to clean the process up, or whether the process everyone acknowledged early in the decade as being out of control when this committee began to readjust its direct and guaranteed loans is still out of control.

Is it possible to get those figures?

Mr. WRIGHT. We will do the best we can. I have got to say that what you are asking for is loan category by delinquency, and when the loan was made and in what category.

[The requested information follows:]

FY 1986 LOSS STUDY

ACTUAL LOSS
RATES
($ in millions)

BUSINESS 7(A)

AS OF	CUMULATIVE SBA SHARE OF DISBURSEMENTS	ACTUAL LOSSES	ACTUAL LOSSES AS A PERCENT OF DISBURSEMENTS
Jun-54	$4.2	$0.0	0.00%
Jun-55	39.4	0.0	0.00%
Jun-56	82.9	0.1	0.12%
Jun-57	179.8	0.1	0.06%
Jun-58	304.6	0.2	0.07%
Jun-59	491.6	0.9	0.18%
Jun-60	637.9	1.9	0.30%
Jun-61	796.9	3.9	0.49%
Jun-62	1,075.8	5.4	0.50%
Jun-63	1,290.3	7.1	0.55%
Jun-64	1,493.3	9.3	0.62%
Jun-65	1,809.4	14.7	0.81%
Jun-66	2,067.7	20.8	1.01%
Jun-67	2,317.1	31.4	1.36%
Jun-68	2,641.2	44.1	1.07%
Jun-69	2,978.5	56.6	1.90%
Jun-70	3,338.5	66.5	1.99%
Jun-71	3,718.6	79.4	2.13%
Jun-72	4,862.5	105.3	2.17%
Jun-73	6,188.2	132.5	2.14%
Jun-74	7,526.2	163.3	2.17%
Jun-75	8,627.7	229.5	2.66%
Jun-76	10,076.0	315.2	3.12%
Sep-77	12,351.7	433.6	3.51%
Sep-78	14,427.4	524.8	3.64%
Sep-79	16,835.8	638.9	3.79%
Sep-80	19,432.9	773.2	3.98%
Sep-81	22,067.7	920.9	4.17%
Sep-82	24,292.8	1,121.5	4.62%
Sep-83	25,925.1	1,372.0	5.29%
Sep-84	28,110.4	1,666.5	5.93%
Sep-85	30,242.9	1,984.0	6.56%
Sep-86	31,703.2	2,329.4	7.35%

FY 1986 LOSS STUDY

ACTUAL LOSS
RATES
($ in millions)

ECONOMIC OPPORTUNITY
LOANS

AS OF	CUMULATIVE SBA SHARE OF DISBURSEMENTS	ACTUAL LOSSES	ACTUAL LOSSES AS A PERCENT OF DISBURSEMENTS
Jun-65	$1.0	$0.0	0.00%
Jun-66	15.9	0.1	0.13%
Jun-67	41.4	0.6	1.44%
Jun-68	69.3	3.0	4.28%
Jun-69	106.8	6.7	6.27%
Jun-70	162.4	12.1	7.45%
Jun-71	233.4	20.1	8.59%
Jun-72	323.9	36.7	11.33%
Jun-73	435.3	54.0	12.41%
Jun-74	535.6	71.4	13.33%
Jun-75	607.3	104.6	17.23%
Jun-76	679.0	133.5	19.66%
Sep-77	786.4	164.5	20.92%
Sep-78	876.0	185.9	21.22%
Sep-79	959.2	207.2	21.60%
Sep-80	1,044.2	229.8	22.01%
Sep-81	1,107.0	250.1	22.59%
Sep-82	1,148.0	273.7	23.84%
Sep-83	1,184.3	297.8	25.15%
Sep-84	1,229.1	31A.8	25.94%
Sep-85	1,287.7	336.8	26.15%
Sep-86	1,321.1	354.0	26.79%

FY 1986 LOSS STUDY

ACTUAL LOSS RATES
($ in millions)

DEVELOPMENT COMPANY LOANS

AS OF	CUMULATIVE SBA SHARE OF DISBURSEMENTS	ACTUAL LOSSES	ACTUAL LOSSES AS A PERCENT OF DISBURSEMENTS
Jun-59	$0.1	$0.0	0.00%
Jun-60	2.2	0.0	0.00%
Jun-61	7.1	0.0	0.00%
Jun-62	14.6	0.0	0.00%
Jun-63	25.6	0.0	0.00%
Jun-64	40.9	0.2	0.05%
Jun-65	61.0	0.2	0.33%
Jun-66	95.9	0.2	0.21%
Jun-67	135.2	0.3	0.20%
Jun-68	178.2	0.5	0.28%
Jun-69	216.2	1.0	0.47%
Jun-70	272.7	3.0	1.10%
Jun-71	314.9	3.9	1.24%
Jun-72	371.4	5.7	1.53%
Jun-73	425.3	7.6	1.79%
Jun-74	495.0	12.5	2.53%
Jun-75	574.9	16.3	2.83%
Jun-76	608.0	21.9	3.60%
Sep-77	651.9	31.0	4.74%
Sep-78	695.0	36.6	5.27%
Sep-79	762.2	42.0	5.51%
Sep-80	832.8	45.9	5.51%
Sep-81	879.7	49.2	5.59%
Sep-82	917.2	54.4	5.94%
Sep-83	1,070.1	57.6	5.38%
Sep-84	1,319.6	63.3	4.80%
Sep-85	1,602.9	69.4	4.33%
Sep-86	1,624.4	76.1	4.68%

FY 1986 LOSS STUDY

ACTUAL LOSS
RATES
($ in millions)

HANDICAPPED
ASSISTANCE LOANS

AS OF	CUMULATIVE SBA SHARE OF DISBURSEMENTS	ACTUAL LOSSES	ACTUAL LOSSES AS A PERCENT OF DISBURSEMENTS
Jun-74	$1.1	$0.0	0.00%
Jun-75	8.2	0.1	1.20%
Jun-76	19.0	0.2	1.10%
Sep-77	30.0	0.4	1.30%
Sep-78	47.3	1.2	2.50%
Sep-79	68.1	2.1	3.10%
Sep-80	92.0	3.8	4.16%
Sep-81	111.7	5.7	5.08%
Sep-82	127.2	8.2	6.41%
Sep-83	142.2	10.3	7.22%
Sep-84	161.5	12.6	7.82%
Sep-85	182.6	15.0	8.22%
Sep-86	195.7	19.0	9.69%

FY 1986 LOSS STUDY

ACTUAL LOSS
RATES
($ in millions)

SMALL BUSINES
ENERGY

AS OF	CUMULATIVE SBA SHARE OF DISBURSEMENTS	ACTUAL LOSSES	ACTUAL LOSSES AS A PERCENT OF DISBURSEMENTS
Sep-81	$41.3	$0.4	0.94%
Sep-82	46.9	1.9	4.15%
Sep-83	50.3	4.0	7.93%
Sep-84	52.5	7.2	13.62%
Sep-85	53.3	11.3	21.11%
Sep-86	53.5	14.6	27.32%

ACTUAL LOSS
RATES
($ in millions)

DISPLACED BUSINESS
LOANS

AS OF	CUMULATIVE SBA SHARE OF DISBURSEMENTS	ACTUAL LOSSES	ACTUAL LOSSES AS A PERCENT OF DISBURSEMENTS
Jun-63	$6.1	$0.0	0.00%
Jun-64	12.1	0.0	0.00%
Jun-65	19.6	0.0	0.00%
Jun-66	32.2	0.0	0.00%
Jun-67	53.6	0.1	0.12%
Jun-68	83.1	0.1	0.11%
Jun-69	114.4	0.2	0.20%
Jun-70	145.6	0.3	0.21%
Jun-71	181.2	0.4	0.21%
Jun-72	218.4	0.7	0.32%
Jun-73	243.3	0.9	0.37%
Jun-74	278.9	1.2	0.43%
Jun-75	319.7	1.6	0.51%
Jun-76	341.6	3.1	0.90%
Sep-77	363.3	5.7	1.55%
Sep-78	378.1	6.6	1.76%
Sep-79	387.0	7.9	2.04%
Sep-80	408.4	8.8	2.16%
Sep-81	437.9	9.8	2.23%
Sep-82	443.6	11.2	2.52%
Sep-83	443.7	12.7	2.87%
Sep-84	443.7	14.8	3.33%
Sep-85	443.7	15.7	3.54%
Sep-86	443.7	18.4	4.15%

FY 1986 LOSS STUDY

ACTUAL LOSS
RATES
($ in millions)

DISASTER LOANS

AS OF	CUMULATIVE SBA SHARE OF DISBURSEMENTS	ACTUAL LOSSES	ACTUAL LOSSES AS A PERCENT OF DISBURSEMENTS
Jun-54	$0.3	$0.0	0.00%
Jun-55	5.3	0.0	0.00%
Jun-56	36.8	0.0	0.00%
Jun-57	50.0	0.1	0.04%
Jun-58	64.1	0.1	0.23%
Jun-59	74.9	0.1	0.55%
Jun-60	79.4	0.1	0.84%
Jun-61	93.4	0.1	1.05%
Jun-62	128.4	1.2	0.91%
Jun-63	145.6	1.5	1.04%
Jun-64	163.5	1.9	1.14%
Jun-65	258.0	2.4	0.92%
Jun-66	469.8	3.2	0.67%
Jun-67	471.8	4.5	0.96%
Jun-68	568.4	7.6	1.34%
Jun-69	600.2	11.4	1.90%
Jun-70	724.5	14.3	1.97%
Jun-71	967.6	17.4	1.80%
Jun-72	1,053.1	22.4	2.13%
Jun-73	1,710.6	27.4	1.60%
Jun-74	1,979.8	31.2	1.58%
Jun-75	2,164.7	45.2	2.09%
Jun-76	2,354.3	55.0	2.33%
Sep-77	2,623.5	67.1	2.55%
Sep-78	4,731.4	78.3	1.66%
Sep-79	6,056.5	96.1	1.59%
Sep-80	8,365.8	123.3	1.47%
Sep-81	9,908.9	156.7	1.57%
Sep-82	10,286.9	222.1	2.16%
Sep-83	10,412.6	318.5	3.06%
Sep-84	10,572.5	419.5	3.97%
Sep-85	10,891.9	553.4	5.08%
Sep-86	11,255.3	702.2	6.24%

Mr. HILER. Right.

Mr. WRIGHT. I know that we can probably go back to 1981. And fortunately, when we first came in and started this whole credit management. And again, the 1982 Act, by the way, helped us a great deal.

Mr. HILER. Yes.

Mr. WRIGHT. At that time, we did not have delinquency data across agency lines and all of the rest of it. And so, Congressman, it was an amazing thing. Because I remember when I first came into OMB that I had 1981 data and I had 1982 data, and the delinquency had gone up 44 percent in that one year, and that is scary, but we did not have it before that. So I can go to 1981 for you, but I will do the best I can.

Mr. HILER. Anything that you can get would be appreciated. Because I think that the key policy question here is not so much how we score it, and probably not so much whether it is recourse or nonrecourse, but it is whether Congress is willing to confront the fact that the issuance of direct loans and guarantees has every bit as much impact on the marketplace as deficits do.

And for Congress to say, somehow, that we are not spending the money directly, but we are providing a loan guarantee and somehow that does not cost anything, that we are fooling ourselves. And it seems to me that that is the key policy question.

And you see Congress approaching this in other areas as well. Because we have a deficit, the Congress is now less inclined to come up with a new spending program, but we mandate the private sector to implement what the Government formerly would have done having the same amount of intrusion, and that is the policy question. And I think that any data that you could give us would be helpful.

I would also just maybe have a comment. When you talked about companies that get into deep trouble and will sometimes sell their assets as a way to try to get restructured and work their way out, I think that there is a difference between selling assets and selling accounts receivable.

When you sell accounts receivable, you are just about to the point where you are going bankrupt. Where if you sell off a division, you have decided, well, gosh, we can do better with the money or the cash that we would get selling that division than we would by keeping it.

I think that in some respects when we sell direct loans and guarantees that we are selling accounts receivable, and that we ought to treat it a little bit more in our thinking as one of these things that we have just gotten ourselves in over our head.

My time has expired, or I have 1 minute remaining. I sure hope that the Congress does move in this area to support the kind of efforts that I think that all of you gentlemen have been in basic agreement with. I think that it is desperately important that we get our credit management house in order.

I think that it is only one part of a much more complex and larger problem, which is to get our Government accounting in order. To me, we just do not have a good handle on the accounting system in the Government. Whether we could move to GAAP type

accounting or something, but get a better recognition of just what we are doing every year in our spending decisions.

You know, to treat investments in highways the same way that we treat our Social Security payment is just not the way to go, and yet it shows up in that same annual deficit figure or in the general debt figure. And credit management is one part of the equation, but only one part. And I hope that you keep pressing your efforts. I yield back, Mr. Chairman.

Mr. WRIGHT. Two comments, Mr. Congressman. First of all, in the President's management report which will be coming up in about 2 weeks, you will see a project in there which I think you will be interested in, and that is to put in the first Federal financial accounting system to replace 400 antiquated, redundant, and uncoordinated systems which have been in place up to now. The new system will standardize and integrate all Government financial operations around 124 primary accounting systems and that is going to be done in about a year and a half.

So I think that we will have the first system, and we will be working very closely with our friends over at GAO and CBO, and all of the rest of it to make sure that it is in there.

The only other thing that I would say is I am going to try to get something for you which I think will be interesting, Mr. Chairman. And that is over the last 10 years, we have moved from direct loans to guaranteed loans at an alarming rate.

Now I do not know the time period on default for guaranteed loans because it depends on the type of loan. My guess is that on the average that it is somewhere between 4 to 6 years.

I am going to try to come up with an analysis for you that may concern all of us. And that is next year we would propose going out with $32 billion in direct and $176 billion in guarantees. Now that has been the pattern for awhile.

What are we looking at from a credit management standpoint on these Federal agencies to have to pick up these guaranteed portfolios that will probably be coming in at an alarming rate over the next 5 years. I just pose that as a question. I do not have an answer. But we will try and get something to you on it, but it could be of concern to all of us.

Mr. HILER. Mr. Chairman, if I just might take 30 seconds to add a comment to Mr. Wright. I have a fairly large ethanol plant in my district that was given a guarantee in 1981 and began operations in 1984. Last week, the Department of Energy cut a check for $126 million to the First Bank of Chicago to take over the loan that had been defaulted on, that First Chicago called in.

So now the Federal Government has $126 million extra outlay this month to pick up one of the costs of those guarantees. So it is very real if you say that was 5 years down the line. You know, what did you say, $450 billion in guarantees outstanding, and a lot of that is bad paper.

Mr. WRIGHT. And it is going to come in on our credit shops at an alarming rate, I am afraid, over the next 4 or 5 years. We will try to get something to you on that. I have not seen that analysis before.

Chairman LAFALCE. That is something that I would be extremely interested in. It is important to keep in mind that one of the rea-

sons that we engage in guaranteed lending is to accomplish a public policy which entails some greater degree of risk than the private sector would take to underwrite such activity in and of itself.

And, therefore, one would expect a default rate higher than the default rate dealing with the private sector alone. The question is one of measurement and balance. We need data in order to make a judgment as to whether the approach that we are taking, with all its greater inherent risks, perhaps is riskier than the public policy goal warrants. Data is essential to make an intelligent policy judgment on those issues.

Having said that, Mr. Gallegly.

Mr. GALLEGLY. Thank you, Mr. Chairman.

Mr. Wright, there have been several comments made on the $227 million in 1981 and the $1.562 billion in 1986. I understood you to refer to these numbers as delinquents. However, I think that I further understood you to say that these loans were beyond delinquent and to the point of default. Or at least in the private sector, they would be reviewed or viewed as loans that had really no value at all.

Mr. WRIGHT. Yes, sir; in the private sector, when I was at Citicorp, we would have written off most of those loans at 6 months. That was our internal policy. These are loans over 1 year delinquent.

Mr. GALLEGLY. Following up on Mr. Hiler's line of questioning. Would you say from your analysis that the problem lies with the collection process, not getting a handle on it quickly enough, or is it the original placement of the loans and qualifications to start with? Obviously, it is significant.

Mr. WRIGHT. Congressman, I would suggest that that is a better question for the SBA itself who really understands exactly what these loans are. From what I can see so far, and I will give you a general answer, but again this is from afar. I am not responsible for the management of that portfolio—it looks to me like you have got two things that have happened within the SBA loans.

First of all, like we were talking about before, you have got a large number of the defaulted guarantees that are coming into the direct loan category, which would automatically increase it, and those would have already gone through some type of credit management by the outside, I would assume, before we picked them up.

Now sometimes I question that, by the way, because they have got very little incentive to collect it. But anyway, let's assume that it has.

The second part that is interesting is the aging of the SBA portfolios of the 0 to 6 months. In other words, delinquent but barely delinquent. It went from $611 million in 1981 to $385 in 1986. So it looks to me like what they have been doing is focusing their heavy collection effort on the front end, that is the easiest to collect, and piling it up in the back end on the seriously delinquent, and then not writing it off and maintaining it on their files.

But again, this could be because of the fact of the makeup between the disaster loans versus the business loans and all of the rest of it. And that is just a general observation.

Mr. GALLEGLY. Thank you, Mr. Wright. Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Ireland.

Mr. IRELAND. Mr. Wright, when does the SBA actually write one off? We know that any prudent banker would write them off in 6 months, but they keep them on for a year.

Mr. WRIGHT. I have got something in here. I just have to find it. [Pause.]

Mr. WRIGHT. I do not have that, Mr. Congressman. I will be more than happy to go and provide that for you.

Mr. IRELAND. Thank you.

Chairman LAFALCE. If I can ask a few more questions.

Mr. WRIGHT. Pardon me, Mr. Chairman. The SBA wrote off $690 million during fiscal 1986. They are supposed to write it off at a year. What they have got is about $1.6 billion sitting out there over a year.

Chairman LAFALCE. Mr. Wright, it seems to me that in discussing agreements and disagreements that there does seem to be a general tone of agreement amongst almost every witness, and certainly the individual Members of the Congress, although not necessarily the collective action of the Congress. It is funny how you can have individual agreement, and then a collective actual total disagreement—that we ought not to sell our assets for the purpose of deficit reduction.

What has gone on in the reconciliation bill is very often in response to, first, other alternatives or, second, other goals such as Gramm-Rudman targets.

But assuming that we ought not to do it for the purpose of deficit reduction, it seems to me that there are two other purposes that would be accomplished. First, debt retirement, and, second, improved credit management techniques.

Is that basically it?

Mr. WRIGHT. I would agree that it definitely was designed as an improved credit management. That is what I tried to get across. I believe that it does reduce the debt. But again, we proposed it as also deficit reduction. And I would say that if you pull it away from deficit reduction, that it is a much larger arena there of offsetting receipts that we carry on as an ongoing business as well as sale of assets that we ought to take a look at.

Chairman LAFALCE. Fine. Then maybe we should.

Mr. GRAMLICH. Could I just comment on that. Your points, debt retirement and credit management are correct.

Chairman LAFALCE. Thank you.

Mr. GRAMLICH. The debt retirement should be viewed cautiously, however, because most people who study these things figure that is an inefficient way to reduce the debt.

Chairman LAFALCE. Speaking of people who study these things, Joe, you mentioned that some economists have seen you in the last couple of months, and you obviously know some people who have studied it. So you will share names with me and papers with me on that, I assume.

Mr. WRIGHT. Sure. I will be glad to. As a matter of fact, it would not be a bad idea to go ahead and submit their testimony in your record of what they gave over at the Senate, if you would wish.

Chairman LAFALCE. Thank you. Without objection.
[The requested information follows:]

Excerpts from the Testimony of Alan Greenspan*

Before
the

United States Senate
Committee on the Budget

February 19, 1987

Government loans have had a checkered history. Almost always at some subsidized rate, they are part of a segment of federal fiscal activities that employ a variety of different vehicles to mask direct payments from the federal government to specific constituents. We see it in the social security system where the present value of payments into the Old Age and Survivors Insurance funds, by both employees and employers, falls short of the average present value of insured benefits. Nonrecourse crop price support loans simulate a market transaction, when in fact, they are an implicit cash subsidy. Premiums into the FDIC and, certainly, the FSLIC create entitlements that will almost surely prove to be significantly in excess of the present value of insurance for depositors.

The most direct evidence of the existence of hidden or partially hidden subsidies is the fact that the market value of federal governments loan assets is only a moderate fraction of reported book value.

It should be a cardinal principal of budget policy that services rendered to constituents by the federal government be accurately labeled: a subsidy, a loan, an entitlement, etc. Too much effort is expended by legislation to obscure the nature and size of payments to constituents. Budget policies of both presidents and congressional committees too often endeavor to mask subsidies by elaborate financial vehicles, which have the aura of market instruments.

This is the reason why I am particularly impressed with the Administration's proposal to immediately sell loan assets upon issuance and without recoursed. The market will immediately create a value for the loan asset that will directly measure the amount of subsidy implicit in the original loan.

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(This material is intended solely for the confidential use of our clients)

In general, therefore, the major argument for sales of existing loan assets is that most of them should not have been there in the first place. Loan asset portfolios of the federal government are too often handled in a nonbusiness manner. Collections are lax, administration poor, and profits generally nonexistent. The reason, of course, is that the employees of agencies running many of these programs understand, as do many of the members of the relevant congressional committees and the recipients of these loans, that they are not in fact loans in a fully commercial sense. They are to a large extent subsidies in the attire of a legitimate loan portfolio. Many, if not most, could be classified as low grade federal junk bonds.

Sales of loan assets to the private sector, however, would create sharply discounted paper, but paper, which when discounted, would have real economic value, a market rate of return, and compelling reasons, on the part of the private sector, to administer the discounted portfolio as a business. This would, in effect, create market place discipline for the allocation of credits and sharply differentiate between subsidies and loans in federal government programs.

The selling off of loan assets, of necessity, will reduce the gross interest received by the federal government to the extent that the saleable assets are, in a banking sense, performing loans. However, such sales will also reduce the carrying cost to the federal government by an equivalent amount, since the proceeds of the loan sale will reduce the required level of outstanding Treasury securities. Moreover, administrative expenses would also be removed, at least on the presumption that the employees and overhead associated with such loan asset interest collections would be eliminated.

The difference between the net proceeds of loan asset sales and their book value represents the amount of subsidy that must be financed by an equivalent amount of federal debt. The discounted part of the loan assets never had an income or a value whose loss will increase future budget deficits. Even the fact that the Treasury can borrow at a lower rate than private business is offset by what must almost surely be a lower cost of administration of loan portfolios by the private sector. Hence, in any meaningful sense, the sale of government loan assets should not materially increase future deficits.

The major credible argument against loan asset sales is that under current accounting procedures they reduce federal outlays on a one-shot basis and, hence, are apt to divert long-term budget deficit reduction from the appropriate focus on core receipts and expenditure adjustments. Moreover, it is argued (correctly) that sale of federal loans has the same impact on interest rates as sales of other federal securities. This suggests, as CBO has noted, that sales of loan assets be counted as a means of financing the deficit rather than as a reduction in outlays.

The basic problem with the federal budget deficit remains the current structural imbalance that will eventually have to be redressed if private capital investment is to add to our competitive capabilities. We delude ourselves into believing that because our long-term budget projections are inevitably benign, time will ultimately resolve the problem one way or the other. It probably will, if for no other reason than financing difficulties will eventually exert pressure for a quasi-permanent solution. The difficulty is that the long-run solution is almost surely going to mean increasing taxes. Such a solution will once again underwrite the seemingly inexorable upward drift of federal spending as a share of the national product. The composition of federal outlays continues to change decade by decade with national defense alternately rising and falling as an overall share. Nonetheless, total outlays seem irresistibly to take an ever increasing share of national economic output. Federal outlays, which totaled only 17% of the GNP during fiscal 1956, rose to 21-1/2% in 1968 at the peak of the Vietnam war but, with real defense outlays sharply lower through 1975, the percentage stabilized. Domestic spending filled the gap of lower defense outlays, however, and continued growth in the latter brought outlays to 22% of GNP by 1976. The inevitable rebound of defense brought total outlays to 24.3% of GNP in fiscal 1983. In fiscal 1986 it had retreated slightly to 23.8%.

The Administration is forecasting a significant decline in the budget deficit and spending's share of the GNP over the next several years, but the gains are likely to be far short of what is now officially contemplated either by OMB or CBO.

The basic budgetary problem is, at root, political. We remain a democratic society in which members of the Congress are competitively pressured in most areas of the country to, in effect, buy votes from their constituents by offering what is perceived of as costless benefits. Subsidies masked as loans is only one such vehicle. The Congress to be sure, in recent years somewhat to my surprise, has endeavored where possible to pull back from that practice and try to hold the line on new programs. That, of course, has been the cause of the recent significant retrenchment in domestic spending as a share of the GNP.

However, proposed catastrophic insurance programs threaten a a reemergence of the upward trend. It may well be argued, as indeed it will, that such government backed insurance is essential to a significant and growing proportion of our population, and that its cost is containable and is, hence, no threat to the budget. But virtually all expenditure programs, considered individually, have merit. The problem is that taken in total we cannot afford them. If Medicare is any guide, catastrophic insurance costs will expand far beyond any current contemplation. Program curtailments and cost containment become politically difficult once a program is in place and constituencies formed.

The only encouraging indication that we may, in fact, be able to balance our fiscal accounts is the way in which the political negotiations on the tax bill requiring revenue neutrality were conducted. I don't believe the tax bill was in fact revenue neutral, but it is sufficiently close to suggest that the Congress does at least have the capability under certain restricted institutional conditions of balancing costs and benefits.

The experience of the last few years raises a question of whether the long-term institutional bias towards increasing federal government outlay shares of the GNP has come to an end. The enthusiasm for catastrophic insurance, however, leaves me skeptical. It is certainly the case that the United States does not yet match most European countries' government spending as a share of GNP. But we appear to be moving in that direction.

Asset Sales Are Not Deficit Reduction

Martin Feldstein*

Testimony before the Senate Budget Committee

February 19, 1987

Thank you, Mr. Chairman. I am very pleased to appear before this committee and to discuss the sale of federal assets as a technique of deficit reduction.

I understand fully the political temptation to rely on assets sales as a means of reducing the budget deficit instead of the more painful process of cutting spending or raising revenue through tax increases and user charges. But asset sales actually do nothing to reduce the real federal deficit. Although the official government accounting rules treat the revenue raised by asset sales as equivalent to increased tax receipts or reduced spending outlays, that is simply a weakness of our government accounting rules.

Asset sales do not reduce the demands of the federal government on our nation's credit markets. And unlike reduced government spending or higher taxes, asset sales do not increase our national saving rate and the resources available for new investments in plant and equipment and in housing.

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* Professor of Economics, Harvard University, and President of the National Bureau of Economic Research.

The sale of government assets has essentially the same effect on our credit markets and on our national economy as the sale of an equal amount of government bonds. To treat asset sales as meaningful deficit reduction is simply phoney accounting.

Indeed, since the term "deficit" has a specific meaning defined by the government accounting rules, I think it would be helpful if we referred to the difference between the government's outlays and its revenue from taxes and user charges as the government's "credit needs." These credit needs can be met by selling old government assets or new government bonds. For the economy and the credit markets, the choice between these two is simply irrelevant.

It is easy to see why asset sales do nothing to offset the current excess of federal spending over tax revenue, i.e., do nothing to change the government's basic credit needs. The essential impact of the federal deficit is to crowd out private investment. When the government spends more than it takes in tax revenue, the bonds that the government issues to pay for this excess must be absorbed in private portfolios. Most of the government bonds are bought by banks, by individuals, and by insurance companies, pension funds and other institutional investors. These government bonds take the places that would otherwise go to new private securities: new corporate bonds, stocks or bank loans that would finance additional investment in plant and equipment and new mortgages that would finance home building. In addition, some of the government bonds are bought

directly by manufacturing businesses and other nonfinancial firms that find the high real yields on government bonds more attractive than additional investments in their own plant and equipment.

Government asset sales crowd out new private investment in exactly the same way as the government's sale of Treasury bonds. If the government sells existing loans or other assets, the resulting securities will displace private investment in the same way as if the government had sold more Treasury bonds. If there is any difference at all, it is that the securities based on federal loans or other federal assets would, if they carry no federal government guarantee, appear to the credit markets to be more like corporate securities than government bonds and would thus tend to raise the cost of borrowing to corporate borrowers relative to the interest rate on Treasury bonds.

I've occasionally read discussions that describe asset sales as helping to reduce the budget deficit in the short run but only at the cost of a bigger deficit later. That is, of course, the way that the government accounts would reflect the asset sale: an increased cash inflow when the federal loan is sold and less future cash because the interest and principal on those loans will no longer be received by the government. But that is simply an accounting fiction with no real impact on the credit markets or the economy.

In describing the effect of government borrowing on the credit markets I have said nothing yet about the inflow of foreign capital which has become so important in recent years.

In 1986, net foreign investment in the United States was $144 billion and accounted for a remarkable 62 percent of all net investment in the United States -- including investment in plant and equipment, the construction of new housing and the accumulation of inventories. Without this massive capital inflow, our net investment would have been less than $100 billion because of the crowding out caused by the government's borrowing. Although the trade deficit that has inevitably accompanied the inflow of foreign capital has been very painful for our trade sensitive industries, the inflow of foreign capital has clearly been critical for maintaining our rate of net investment.

The key point about this foreign capital inflow in the context of today's discussion is that substituting the sale of government assets for the sale of government bonds would not alter any of this arithmetic. The inflow of foreign capital and the net amount of private investment in the United States will not depend on the extent to which the government uses asset sales rather than new Treasury bonds to finance its credit needs.

In your invitation to testify you asked me to comment on the proper accounting for asset sales. The simplest procedure would in principle be to redefine the budget deficit so that it excludes government lending activities and the sale of government assets. Although this would preclude the sale of assets as a means of reaching the deficit target, it would also have the adverse effect of encouraging an increased volume of government soft loans in place of current direct spending. In short, either way of measuring financial asset transactions is open to abuse.

Perhaps the best thing would be to maintain the current definition of the budget deficit but to state the Gramm-Rudman-Hollings deficit reduction target in terms of the federal government's "credit needs." This would eliminate asset sales as a way of meeting the Gramm-Rudman-Hollings targets. Keeping the traditional measure of the deficit as a central concept of the budget would reduce the temptation to substitute soft loans for direct spending.

Let me comment finally on the argument that these asset sales are desirable in themselves because they get the government out of activities in which it doesn't belong and because such asset sales would make clear the extent of the subsidy involved in the existing loans. I would certainly applaud eliminating the government from some of its current credit activities, although I believe that the proposed asset sales would by no means stop the government from initiating new loans under these old programs. And while it is worthwhile to have the financial markets indicate the extent of the subsidy inherent in the government loans, I think the advantage of this clarification is outweighed by the disadvantage of mismeasuring the size of the true deficit.

In short, I hope that the Congress will avoid the temptation to achieve an artificial reduction in the budget deficit by the relatively painless route of asset sales. Asset sales are simply not real deficit reductions. They do not reduce the government's demand on the credit markets or its impact on the economy. The only meaningful way to reduce the budget deficit is the old fashioned and painful one: spend less or tax more.

Thank you.

Mr. WRIGHT. It is interesting.

Chairman LAFALCE. Go ahead.

Mr. GRAMLICH. So, if this is done simply for the purpose of retiring the national debt, in effect what you are doing is replacing Government securities that are in great quantity, that the private market knows, and so forth, with securities that are unknown and that may sell at a negative premium.

So, there may be some initial cost in that. And I think that the wisdom of the policy really hinges on the credit management. If it is true that the private sector can——

Chairman LAFALCE. Well, let's get into credit management then.

Mr. GRAMLICH. All right.

Chairman LAFALCE. You know the problems that I have in selling assets to reduce deficits. I think that I have shared that.

Mr. GRAMLICH. We all have those problems.

Chairman LAFALCE. We all have those problems. The problem that I have with selling assets to improve credit management techniques is that is the sledge hammer when maybe you should be using the scalpel approach. I mean that is really a drastic resort, that we are going to improve credit management techniques by getting rid of all paper that we are holding.

That is not really improving your techniques all that much, is it? That is just getting rid of the problem.

Mr. MCMILLAN. I think that the problem is that it is in a situation where the management has to suffer the economic consequences. The way that we account for it in Government accounting is that we do not suffer the economic consequences at all.

Chairman LAFALCE. Well, that goes to a question of scorekeeping, budgeting, et cetera, but not to the question of credit management. I would like for the panel to respond to that. Mr. Wright.

Mr. WRIGHT. I do not believe, Mr. Chairman, that we are taking the sledge hammer approach.

Chairman LAFALCE. My problem is that in order to deal with the problem of credit, you say remove our status as creditors.

Mr. WRIGHT. Well, except that——

Chairman LAFALCE. George Bernard Shaw said, "The way to deal with the problem of the poor is simple—exterminate them."

Mr. WRIGHT. Except that what was proposed in the pilot was not the wholesale sledge hammer approach of elimination of these portfolios. Let's take a good example.

Chairman LAFALCE. As against the total universe, no.

Mr. WRIGHT. No; I mean on the individual.

Chairman LAFALCE. But as against the assets in particular, the sledge hammer for that.

Mr. WRIGHT. No; I mean the assets in particular. The rural development insurance fund which the first package is going to be going out as announced. I think that it is going to be a face value of $1.9 billion to come up with a net value of $1 billion. There is $8 billion in that total fund. We purposefully did not go and include any large percentage of that——

Chairman LAFALCE. So what percentage of that fund would you be calling for?

Mr. WRIGHT. 20 or 25 percent.

Chairman LAFALCE. What is the average percentage of the total outstanding portfolios that you are calling for sale, and what would the percentage be for SBA?

Mr. WRIGHT. Oh, let me see.

Chairman LAFALCE. If we have it, fine. If we do not have it, then maybe you could just give it to me.

Mr. WRIGHT. We will definitely get it for you. I am just trying to think if I can give you a fast answer. Give me just one minute.

Chairman LAFALCE. Sure.

[Pause.]

Mr. WRIGHT. Let me get that for you, Mr. Chairman.

[The requested information follows:]

PILOT LOAN ASSET SALES: Face value sold, FY 1988 Budget

	FY 1987 sales as % of loans outstanding at end of FY 1986	FY 1988 sales as % of loans outstanding at end of FY 1987
Agriculture:		
Rural housing.....	7.5%	4.5%
Rural development.....	23.5%	18.6%
Rural Elec Admin.....	NA	2.6%
Rural telephone bank....	NA	33.4%
SBA:	NA	NA
Business loan inv fund..	NA	26.2%
Disaster loans.....	14.2%	20.4%
Development companies...	NA	53.7%
HUD:	NA	NA
FHA fund.....	7.1%	9.1%
Rehabilitation loans....	NA	47.9%
Community development...	8.9%	59.5%
Hsg for eld & handcppd..	NA	7.5%
Education:	NA	NA
College housing loans...	44.1%	75.9%
Higher ed facilities....	NA	44.4%
Veterans Administration:	NA	NA
Vendee loans.....	NA	NA
Export-Import Bank.....	14.1%	11.2%
Interior:	NA	NA
Bureau of Reclamation...	NA	28.5%
HHS:	NA	NA
Medical facilities.....	NA	100.0%
HMOs.....	NA	100.0%
Transportation:	NA	NA
Railroad rehabilitation.	NA	91.8%

18-Mar

Chairman LAFALCE. All right. What I am trying to find out, is SBA being asked to take a disproportionate portion of its portfolio in comparison with the rest of the agencies? I do not know. I am just curious. Let me go to something else now.

Mr. Wolf said that one of the problems that we have, when you, Mr. Wright, suggested that maybe, we could sell some of our assets and use proceeds to retire debt, is that we do not have a balance sheet.

And the fact that we do not have a balance sheet is a very, very severe problem, it seems to me. Because it is difficult to deal with the Federal budget without knowing what our balance sheet is.

And Mr. Wright, I remember back in November or December of 1986 when there were leaks from the administration as to what was going to be in the State of the Union Address and the budget proposals, and we talked about a number of things.

They were going to come up with a competitiveness package, something that both you and I had been very, very concerned about for eons. But also, they were going to come forth with budget reform proposals. And Don Regan was talking publicly in interviews about a capital construction budget which would go a long way toward a balance sheet.

What happened on the way to the forum?

Mr. WRIGHT. Well, as I mentioned, Mr. Chairman, we completed a full general ledger, a Federal Government general ledger, about 6 months ago. And as I mentioned earlier, we will be coming in with the project, to come in and develop a full Federal Government-wide accounting system by the end of calendar 1988.

Chairman LAFALCE. Will it have as its end result a balance sheet for the Federal Government?

Mr. WRIGHT. It will have a balance sheet, and we will be able to put together a balance sheet. And part of the discussion that we are going to have between now and then is how far we go into the capital budgeting area.

Chairman LAFALCE. That is crucial though, is it not, that capital budget area?

Mr. WRIGHT. Yes.

Chairman LAFALCE. Give me a ball park figure now. If we were to capitalize those items that virtually everyone would agree should be capitalized, about which there is not too much debate, using general accounting principles, how much of a reduction in the budget deficit do you think that we would experience for fiscal 1988?

Mr. WRIGHT. I do not know, Mr. Chairman. I have seen those numbers somewhere. I can get you some estimates on that.

Chairman LAFALCE. Mr. Gramlich has it at his fingertips.

Mr. GRAMLICH. There are essentially two changes that we would make in going from the present cash deficit to the——

Chairman LAFALCE. Are you going to answer my question as to the amount?

Mr. GRAMLICH. Yes.

Chairman LAFALCE. Okay, good.

Mr. GRAMLICH. And the first change is the credit budget. You have seen the numbers, and they are given in our table 1. The second change is——

Chairman LAFALCE. Refresh my recollection, how much?

Mr. GRAMLICH. In fiscal 1988, going to a capital budget on the credit account would raise the deficit by, I think, $8 billion. And then, the second change would be where the Federal Government makes large capital expenditures, such as for missiles. That would be the outstanding case, missiles and other defense goods.

Chairman LAFALCE. And Mr. Hiler's roads.

Mr. GRAMLICH. Even roads are mostly financed with grants to local governments. And, I think, GAAP procedures would not consider that as capital investment. But if you did it for purchases of defense equipment, you would be into a real thicket of evaluating how fast those things depreciate. Because what you would count as spending would be the depreciation, not the outlay.

Most estimates would have that lowering the deficit by, maybe, something on the order of $30 to $40 billion. Those are not enormous amounts. They may even be a generous estimate of how much it would lower the deficit.

But the point is that you have a problem of estimating rates of depreciation on military goods which are not sold on the market. Different rates of depreciation could change that estimate quite dramatically.

So, there is really no good answer to your question. I mean, the fact is that we really do not know how much a capital budget would change the deficit. Mr. Wolf.

Mr. WOLF. I guess that I would disagree a little bit. We have all spent a lot of time looking at capital and loan programs. If you made those changes on just capital and loans, I think that our numbers would come up somewhat higher. I know that CBO is working on it and OMB.

There is not complete agreement. I think we are beginning to get more agreement about the concepts. I think that you might find the numbers somewhat different.

Chairman LAFALCE. Well, for example.

Mr. IRELAND. In which direction?

Mr. WOLF. A lower deficit.

Mr. GRAMLICH. That is what I said. Maybe $30 billion or $40 billion.

Mr. WOLF. I think that our numbers would come up even a little bit lower than that, or a higher reduction in the deficit.

Chairman LAFALCE. A higher reduction, what are you talking about, $40 to $50, $60 to $70?

Mr. WOLF. Yes.

Chairman LAFALCE. Which one?

Mr. WOLF. At this point, I would say $30 billion is not a high enough number.

Chairman LAFALCE. And that is almost exclusively defense?

Mr. WOLF. No.

Chairman LAFALCE. Then you disagree.

Mr. WOLF. Mr. Gramlich, using his numbers.

Chairman LAFALCE. Using his numbers, I understand.

Mr. WOLF. It seems to me that when you have a highway system, we own it, everybody owns it. Whether we invest in that or whether we invest in defense, which we all own, there is relatively little distinction.

Mr. WRIGHT. But Mr. Chairman, if you are talking about the main impact of the deficit as to how much you have to borrow from the private sector in order to keep the Federal Government going, you are going to have almost no effect.

Mr. WOLF. That is essentially the ultimate question.

Mr. WRIGHT. I know.

Mr. WOLF. Is the deficit the number that we are borrowing, or is the deficit the cost to run our Government which is different if you look at capital investment than it is for paying our salaries?

Mr. MCMILLAN. That is why most businesses have an income statement and a cash-flow statement.

Mr. WOLF. That is right. And that is essentially what we have been suggesting.

Mr. MCMILLAN. For a different purpose. We need a cash-flow statement.

Mr. WOLF. Well, we have a cash-flow statement.

Mr. GRAMLICH. Well, that is what you have got.

Mr. WRIGHT. That is what you have got right now.

Mr. GRAMLICH. You have not got the other two.

Mr. MCMILLAN. No; we do not. Not if a loan guarantee is scored as an outlay.

Mr. WOLF. No; a loan guarantee, it is not.

Mr. WRIGHT. But it is not.

Mr. GRAMLICH. It is not.

Mr. WOLF. A loan guarantee is not scored at all. A loan guarantee, from the standpoint of the way that the budget reflects it, right now, is free. Only the defaulted guarantees that come back in result in cash outlays that are scored as an expense.

Mr. MCMILLAN. OK, I stand corrected. But it would be scored as an authorized item.

Mr. WOLF. Well, this is the reason why the credit budget was established. Within the credit budget you have separate credit levels for both direct lending and guarantees, and that is the reason that it was established.

Chairman LAFALCE. Right now under the reconciliation bill, which is the law of the land, what is going on in the agencies?

Mr. WRIGHT. On the Loan Asset Sale Program?

Chairman LAFALCE. Yes.

Mr. WRIGHT. By the way, I have some information on the SBA question that you asked earlier. For fiscal 1987, a face value of $800 million on the SBA disaster loans is scheduled to net out $277 million. On the total SBA loans, if you want a percentage, you are talking about $9 billion out there that is outstanding. If you want to take just the SBA disaster portion of it by itself, that is $4.222.

So on the total package, you would have, let's say, .08 or .09 percent of the total. On just the disaster, you would have 20 percent, about the same as the rural development insurance fund.

Chairman LAFALCE. Is that the only other direct loan within the Federal Government; in other words, are we only comparing it to the rural development, or are there others to compare it to?

Mr. WRIGHT. The rural housing is face value $2.2 billion.

Chairman LAFALCE. Well, why do you not give me those percentages later, Joe, for all of the agencies and all of the percentages.

Mr. WRIGHT. OK, I would be glad to. What we had was reconciliation for fiscal 1987 loan asset sales, which included $7 billion to result in a net of $4.794 billion. The other sales that are included in the pilot program added another $935 million. So a total of about $8 billion in face value to result in $5.3 billion net receipts for fiscal 1987, the year that we are in right now.

Chairman LAFALCE. But that passed in October, right?

Mr. WRIGHT. Yes, sir.

Chairman LAFALCE. What has happened from October to March 10th?

Mr. WRIGHT. OK. Almost all of our agencies have gone out with the RFP's for the financial consultant, or already have them on board. This includes SBA, who has gone out with the RFP as I mentioned earlier; Farmers Home; Export-Import Bank; and the Department of Education.

Then you have the first announcement of the underwriters that has already been made by Farmers Home on the rural development insurance fund that was done about 2 weeks ago. They will announce the actual sale probably in about 4 to 5 weeks.

SBA, itself, should have their financial advisor announced in mid-March, and then I cannot tell you exactly what their timing is, Mr. Chairman. Let's suppose that it would be July/August. It just depends upon how long it takes them to go on ahead and get ready and working with their financial advisor. Because it is a pilot, we are not putting them on a strict deadline.

Chairman LAFALCE. You mentioned in your verbal presentation that your proposal was just for 1 point something percent of the reconciliation, and that it was 2 point something percent.

Mr. WRIGHT. The original proposal was $4.4 billion gross to come up with $1.7 billion net.

Chairman LAFALCE. Right. But you said as a percentage of the total outstanding portfolio that it was about 1.7 percent. And after reconciliation, they virtually doubled it.

Now if we are talking about from 1 percent to 2 percent of an overall Government portfolio, then how do we get to a SBA percentage of approximately 20 to 25 percent? Explain that for me.

Mr. WRIGHT. Well, let me give you an example. You do not want to include—there are large blocks of portfolios that are exempt that I mentioned before. The CCC—deficiency loans that are made to farmers—and many of our international loans.

Chairman LAFALCE. What percentage of the total portfolio have you exempted?

Mr. WRIGHT. OK. Let me give you a detail on the——

Chairman LAFALCE. You see what I am getting at. If you have exempted 75 percent or 50 percent, and then you are still using the 1- or 2-percent figure as a means of justifying it on a pilot basis, but it is not 1 or 2 percent for any given agency, but it is 20 to 30 to 40 percent for a given agency, that is not pilot. It is not pilot for a given agency.

Mr. WRIGHT. Let's talk about a given agency. I think that 20-percent is a pilot, and let me explain why.

Chairman LAFALCE. It may be so, but do not give me again 1 percent or 2 percent.

Mr. WRIGHT. OK.

Chairman LAFALCE. It sounded persuasive until I started thinking about it, and then I was troubled by it.

Mr. WRIGHT. Well, the reason that I did that was because I was responding to the allegation of a fire sale of all of the financial assets that we have got in the Government, and I just wanted to put that in perspective.

Chairman LAFALCE. OK, but it may be a fire sale for a given agency.

Mr. WRIGHT. I do not think that 20 percent is.

Chairman LAFALCE. Maybe it is not a fire sale, but is it a pilot program?

Mr. WRIGHT. I believe so. Now the problem is if you went too much below that, I am not so sure that you would have a package that would be of interest to your large firms who would want to come in and bid on those proposals—I do not know that. Second, I do not think that the agency would take it seriously.

These agencies, if you went and you put something together on the order of 5 percent, they could do that on a weekend. And I do not believe that it would impact the rest of their credit management program.

Chairman LAFALCE. Are there any comments from any of the other panelists?

Mr. WOLF. The only comment I would make, I guess, is that we tend to talk about these things in the $1.8 billion range or the total portfolio of the Government. We probably have 200 different portfolios of different types of loan. I, just for fun, was counting it up one time.

If you take the portfolios of Bank of America, Citibank, North Carolina National Bank, and Continental Bank, that is about what our portfolio totals. And, it is scattered all over the place. We do not have good data. And you do have to look at what you are doing. For individual portfolios within SBA, for each of the individual pieces, the experience is widely different. It is very difficult to judge. There are a lot of misconceptions about what is in there, frankly.

Chairman LAFALCE. Would you call 20 to 30 percent of a portfolio a pilot program, Mr. Wolf?

Mr. WOLF. You could but it is——

Chairman LAFALCE. You could, but it would be wrong?

Mr. WOLF. I do not know where I would come out. I would not say 20 percent is a wholesale sale of the portfolio, no. But the problem is that you have to look at every one of these portfolios individually and decide. What might make sense for one of them is clearly not going to make sense in the next one that you look at.

But we tend to talk about these loans in global terms, that the whole portfolio is in such and such a condition or whatever. You cannot do that. As you are doing, you have got to get down to the individual portfolios and determine the impact on SBA.

Chairman LAFALCE. Do any other members of the committee have questions?

Mr. DEFAZIO. Yes.

Chairman LAFALCE. Mr. DeFazio.

Mr. DEFAZIO. Just to follow up on the 20 percent that we would be disposing of in this year.

Chairman LAFALCE. We just made that 20 percent up. What is the approximate figure, by the way?

[Pause.]

Mr. DEFAZIO. Well, all right.

In any case, the proposal for this year which may or may not constitute 20 percent, how are they selected, are they selected as the most randomly, the most creditworthy? How are they selected—are they the best part of the total portfolio?

Chairman LAFALCE. And Mr. DeFazio, if I may interrupt. Counsel advises me that it is probably not 20 percent, but that it is probably closer to between 30 and 40 percent of SBA's total portfolio in the FY 1988 proposal.

Mr. WRIGHT. Well, no; SBA's portfolio, Mr. Chairman, I believe that it is around 20 percent.

Chairman LAFALCE. Of the?

Mr. WRIGHT. Of the disaster portfolio, I believe.

Chairman LAFALCE. That is the first one in question, yes.

Mr. WRIGHT. For fiscal year 1987.

Chairman LAFALCE. Go ahead.

Mr. DEFAZIO. Well, what are the attributes of these particular assets that are being sold? Are they chosen for marketability?

Mr. WRIGHT. No; here is what happens, which is one of the reasons they bring in the financial advisors, that is what the agencies work with the financial advisor on the front end to determine what the makeup of the portfolio is going to be, and how much current versus how much very near term delinquent. We do not have any real defaulted paper in there.

Mr. DEFAZIO. Well, what I am getting at then, the ultimate objective being to improve the credit collection procedure, and you said that 5 percent would not stimulate the agency to change its procedures.

But if a portfolio is chosen that, perhaps, is the most creditworthy portion of that portfolio and it is disposed of, and we are left with the less creditworthy, it seems to me that we are moving away from our objective.

I mean, is there any guarantee that the advisor is not going to come in and say, well, this is the most marketable portion, and your objective is to create this revenue; you are going to have to sell these; these are the best and more creditworthy part of your portfolio?

Mr. WRIGHT. We have not designed the face to the net value as the highest return that we can possibly get on the sale. So I do not believe that there is a great deal of pressure there to come up with the highest quality that they possibly can, to come up with that net value.

And by the way, if we do not make that net value that is in reconciliation, that is going to be some information as to what the subsidy amount is on that portfolio itself, which is part of this.

I certainly cannot put OMB or any one of these agencies behind what the results are going to be of those sales. Again, one of the reasons that we are talking about pilot is that you get to take a look at credit reform. When you establish a market value for these, in part, that is establishing what the subsidy value is.

Mr. DEFAZIO. Do you believe that there should be no subsidy? I mean, it seems to me that the SBA is a lender of last resort for many people, and there is a social policy involved there, attempting, basically, to make some capital available to businesses that may or may not be able to go into the private sector and borrow these moneys.

I mean, if the pilot becomes 20 percent a year over 5 years, and we have disposed of the portfolio, do you anticipate making future loans to other than totally creditworthy businesses?

Mr. WRIGHT. No; I believe that the lender of last resort philosophy is a good one for those areas where it is established that the Federal Government has a social or an economic interest. What I might say is when you talk about subsidies, that it is not necessarily just an interest rate subsidy. That is the easiest one.

Another subsidy could be the payment terms. Another subsidy could be the default terms. Another one could be, let's say, for college students who do not have to pay anything back for 6 months after they graduate. That is all part of the subsidy package, and there is a good reason for it.

So, I think that we have gone too far on many of our interest rate subsidies. I think that we have gone too far in many of our collection procedures to where we are allowing people to, basically, default, and then not going through good collection practices. But no; I would not say that the Federal Government should not provide subsidies. By the nature of it, we are a lender of last resort.

I would also say, Mr. Chairman, that there is an intention that I have got that we had mentioned. And that is the lending practices, I think, of the SBA in the future can be more tightly defined toward those small businesses who provide a real opportunity for future growth in the country in terms of jobs and the economy. And we would be more than happy to work with that. That is another form of subsidy, lending to the wrong businesses.

Mr. DEFAZIO. All right. But I think that a lot of your objectives could be accomplished without the actual sales. I mean, with scrutiny, that we could develop those same sort of criteria and change the criterion on which the loans are made.

Mr. WRIGHT. Yes; you could.

Mr. DEFAZIO. Mr. Chairman, I yield back the balance of my time.

Chairman LAFALCE. Mr. McMillan.

Mr. MCMILLAN. Thank you very much. Let me pursue that a little bit. Mr. Gramlich, on page eight, you had some figures which included an estimate of the subsidy and the budget.

Is that more or less an estimate or is that a fairly studied figure from CBO?

Mr. GRAMLICH. An estimate.

Mr. MCMILLAN. An estimate?

Mr. GRAMLICH. Yes.

Mr. MCMILLAN. And it would then include in it, within the definition of subsidy, would it include matters such as anticipated default on loans?

Mr. GRAMLICH. Yes.

Mr. MCMILLAN. Getting back to the question of anticipated outlays, if we are looking at next year's budget, do the projected out-

lays include anticipated default on the asset portfolios that we have under discussion?

Mr. GRAMLICH. No; I mean the logic would be that the credit subsidy cost would be the implicit subsidy of all of those actions that you made this year.

Mr. MCMILLAN. Namely, interest rate differential?

Mr. GRAMLICH. Or higher default, or payment terms or whatever. I mean there are a whole set of those.

Mr. MCMILLAN. We are not given a figure, let's say, to be a part of our consideration of the anticipated default on the assets that we have under consideration for this year which, probably in real terms, is going to be the cash cost, the cost to us in the coming year?

Mr. GRAMLICH. It would be a cash cost in the coming year, but it is a result of actions, fiscal actions, made this year. So, one point of this reform is to separate the cash transactions from the real decisions by placing these transactions in the proper year in some sense.

According to the OMB proposal, the agencies would then just appropriate to their loan revolving fund the amount that covers on some expectation the present value of all of the future costs of a given transaction. From there on, the loan revolving fund handles it. That is one way to think about it.

Mr. MCMILLAN. Thank you.

Chairman LAFALCE. Gentlemen, I want to thank you very, very much. I think that this has been very educational for us. It is our first touch at this complex subject. We will be visiting it again Thursday. It certainly has been helpful to me, and I think to the entire committee, and I hope to the entire Congress. Thank you very much.

[Whereupon, at 11:20 a.m., the committee adjourned, subject to the call of the Chair.]

THE ADMINISTRATION'S PROPOSAL FOR FEDERAL LOAN ASSET SALES AND CREDIT PROGRAMS

THURSDAY, MARCH 12, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10:04 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Present: Chairman LaFalce; Representatives Cooper, Hayes, Campbell, Ireland, Hiler, Slaughter, McMillan, Rhodes, and Hefley.

Chairman LAFALCE. The Small Business Committee will come to order.

Today is our second day of full committee hearings on the administration's budget proposals for Federal loan asset sales and credit programs. Last Tuesday's hearing reviewed both the objective and the procedure for the administration's proposals for these initiatives.

This hearing is continuing to examine the loan asset sale issue for what it means to the future of the SBA and its loan programs, and also for what it means for loan assets held for a number of other Federal departments and agencies.

The prior hearing brought out the committee's considerable direct interest in the loan asset sales issue. The administration is proposing to expand the Government-wide loan asset sales to a level of $11 billion in fiscal year 1988. A major part of this total would be in sales of approximately $3 billion in SBA loan assets.

But because of its no recourse sales policy, the administration is forecasting a return to the taxpayers of less than one-third face value. I am pursuing with the administration, my questions, unanswered at Tuesday's hearing, as to why the SBA loan asset sale is such a large part of the administration's Government-wide scheme; and how it can be characterized as a pilot sale when it would be for such a large part of the agency's $8 billion portfolio.

This morning's hearing will bring us the valued advice of the financial and investment banking community which will have to advise on, and participate in, the marketing of the Government loan assets proposed for sale. We also need their assessment of the impact of initial sales of loan assets on the existing markets.

OMB contends that despite higher prices paid, the Government would not gain revenues through recourse sales. I am not sure that this is correct. In any case, initial sales must be on a true pilot

basis. Agencies and their advisors must have sufficient time to proceed, and Congress must be assured that there will not be unnecessarily diminished returns to the taxpayers.

Today, we also have before us the Small Business Administration witnesses who will update the committee as to the selection of a financial advisor, and explain the agency's participation in fiscal year 1987 and 1988 pilot loan asset sales programs, and the new credit reform initiative.

Do any other members have opening statements?

Mr. IRELAND. Mr. Chairman, the hearing we had the day before yesterday was an outstanding start on this issue. I think you have set the stage, not only for this committee, but for other committees of Congress that are going to be looking into the matter of asset sales. I tip my hat to you for a job well done. Thank you.

Chairman LAFALCE. Thank you. We have one panel this morning consisting of Mr. Miner Warner, Government Finance Group, Salomon Brothers; Mr. Lawrence Blume, vice president, Government Guaranteed Financing Department, Merrill Lynch Capital Markets; Mr. Harold Cooke, vice president, The First Boston Corp.; Mr. Michael Clare, vice president, Citicorp Investment Bank; and Mr. John Moffitt, Acting Associate Administrator for Management and Administration of the Small Business Administration.

Gentlemen, if there is no objection we will put the entire text of all your remarks in the record. Hearing none, so ordered.

We would ask each of you to attempt to present your remarks or summarize your remarks within from 5 to 10 minutes. Certainly no more than 10. And with that, please proceed.

Mr. Warner, we will start with you and we will go right down the line.

TESTIMONY OF MINER H. WARNER, VICE PRESIDENT AND MANAGER, GOVERNMENT FINANCE GROUP, SALOMON BROTHERS, INC.

Mr. WARNER. Thank you Mr. Chairman. With your permission and at your suggestion we will include in the record our prepared remarks and summarize certain of the key points we would like to make today.

Chairman LAFALCE. Terrific.

Mr. WARNER. Salomon Brothers is in the vanguard of Government asset sales. We are co-lead manager on the Conrail issue and very recently we were selected as co-lead manager on the Farmers Home Administration $1 billion asset sale for the Community Development Program.

We are pleased to have this opportunity to appear today.

Chairman LAFALCE. You are trying to corner the market.

Mr. WARNER. A modest participation, Mr. Chairman.

Much of corporate America has developed experience with loan sales and packaged assets over the past 2 or 3 years. All kinds of corporations, banks, thrifts, homebuilders, and insurance company pension funds have developed this experience, and for a number of reasons. There are a number of reasons behind these sales, including maximizing profits, minimizing capital requirements, redeployment of assets and liabilities, and tax considerations.

In fact, we estimate that today, the aggregate market for structured asset sales is about $540 billion. I think that figure of $540 billion gives some relative scope to what the Government is doing right now.

And what we are talking about, of course, are mandated loan sales, mandated both by the administration——

Chairman LAFALCE. $540 billion of what?

Mr. WARNER. $540 billion of asset-backed financing. Collateral for these asset-backed financings involve, principally, residential mortgages; also, commercial mortgages; also, car receivables; to a minor extent, credit cards. Other kinds of receivable financings are being developed right now.

The Government loan sales which were mandated pursuant to the Omnibus Budget Reconciliation Act in October 1986 pertain to four portfolios: Two portfolios by the Farmers Home Administration, community development and rural housing, single family rural housing; Export-Import Bank of the United States direct loans, and Department of Education college housing which was mandated, not pursuant to OBRA, but pursuant to amendments to the Higher Education Act.

Attached to my report, Mr. Chairman, is a paper which we have done on those mandated sales, which may be useful.

OMB gave guidance on the loan sales pursuant to the guidelines dated July 8, 1986, calling for full nonrecourse loan sales. And just last month SEC Chairman Shad gave testimony which indicated, clearly, certain of the avenues for implementation of these Congressionally-mandated loan sales.

Sales are intended to achieve several benefits. We note four. One is dollar-for-dollar deficit reduction. Another is a diminished use of indirect Federal credit. Third is a management objective which is greatly improved loan administration and program administration practices. And finally, a more accurate measurement of taxpayer subsidies.

In testimony which I gave before the Senate Governmental Affairs Committee on May 13, 1986, which in fact, was the first testimony from Wall Street on loan sales, I made four points which with your permission, I would like to read. They are found on page four of my testimony.

First, is that in order to maximize value it will be necessary to sell credit-worthy loans on an individual program-by-program basis. Loans cannot be mixed from different programs together effectively. Second, it is the agencies which have the programmatic expertise to package and implement these sales. Third, loans must be packaged rather than sold individually to create a real market. And as a general rule, it is only these packages which can obtain ratings and which hence will be investment grade and which hence will maximize proceeds to the Government from these nonrecourse loan sales. And finally, of course, third party servicing is available for credit-worthy loans.

The 1987 loan sales suggest that those four points remain valid. The experience to date, I think, has been very satisfactory from the Government's point of view.

Chairman LAFALCE. What was your early experience?

Mr. WARNER. I am saying, Mr. Chairman, that in our view the early experience, so far in 1987, validates our thoughts back in 1986 with respect to the more useful approach to loan sales on a nonrecourse basis.

With respect to the four mandated loan sales, requests for proposals or RFP's have gone out on all the portfolios. Three of the four portfolios have, in an orderly and timely fashion, selected financial advisors. The fourth, Eximbank, currently is going through that process right now.

One of the agencies has not only selected its financial advisors but proceeded in a highly competitive and useful fashion to select lead underwriters for the sale of that portfolio, namely, the Farmers Home Administration community development loan portfolio. And, as I think you heard, OMB Deputy Director Wright on Tuesday indicated that that portfolio would be forthcoming to the sales process. I think he mentioned that in his testimony in June.

So far then, it would be our experience, looking at it from the Wall Street vantage point, that the Loan Sales Program is proceeding in an orderly, correct, highly competitive, and effective manner, from the Government's point of view. That leads, of course, to the nonrecourse question.

With respect to the OMB guidelines that I mentioned earlier of July 8, OMB calls for complete nonrecourse. Nonrecourse sales are available, in our judgment, for tens of billions of dollars of loan assets by the Government. There are tens of billions of dollars out there in various portfolios which can be sold completely without recourse on a structured and rated basis.

However, I think we all appreciate that there are some loan portfolios which cannot be sold in a cost-effective manner without recourse at all. Those programs would be characterized essentially by three characteristics. One is a high default rate. It is not possible to structure around a high default rate. Second, inadequacy of documentation and recordkeeping, and historical recordkeeping. Because after all, in a nonrecourse purchase, that is what an investor is purchasing.

And finally, agency forbearance.

Chairman LAFALCE. It sounds like the definition of SBA.

Mr. WARNER. Mr. Chairman, I will address the SBA portfolio in just a minute.

As you all appreciate, there are certain Government programs which are designed to be more in the nature of either grant programs or oriented toward a distressed constituency. By definition, these will generate loan assets which cannot be structured at any reasonable level to achieve reasonable proceeds back to the Government.

I might mention at this point that with respect to the GAO report, their second and final recommendation, and I quote here, I found useful, and I think it merits continued consideration by all of us. And that is the recommendation to classify for budget purposes the Government's maximum contingent liability under limited recourse loan sales as borrowings and classifying the unencumbered sales proceeds as receipts. I think that is a serious suggestion which merits further deliberation by all of us.

Going on to the Small Business Administration portfolios which were under discussion at the hearing today, we have to say that we do not have, currently at our disposal, sufficient basic facts on the two portfolios being discussed to base a credit judgment. As SBA is currently going through the RFP process to select a financial advisor on these loan portfolios, we would be very interested in seeing the results of that RFP and recommendations by the financial advisor, and at that point come in with our judgments. But at present we do not know enough to suggest whether or not the SBA portfolios under discussion can be sold without recourse at acceptable rate levels.

In conclusion, Mr. Chairman, I would like to say that in our judgment the loan asset sales are off to a good start. As I mentioned to start with, the total planned asset sales represent only a very modest percentage of an already vast existing and well-received market. We are fully confident that if they are well structured and rated, that the process is going to be very useful and very satisfactory to the Government.

In conclusion, I would say that the Wall Street response has been very vigorous and it has been highly competitive. I think all of that will prove to be useful during this process. Thank you.

Chairman LAFALCE. Thank you very much, Mr. Warner. We are not going to ask questions until the entire panel has concluded. But I have just one.

You are the vice president of the Government finance group. What is Dave Stockman's position? He is with Salomon, is he not?

Mr. WARNER. He certainly is. Dave Stockman is in the corporate finance department.

Chairman LAFALCE. That is opposed to Government finance.

Mr. WARNER. That is right. He is involved in corporate financing and working with major corporations.

Chairman LAFALCE. Thank you.

[Mr. Warner's prepared statement, with attachments, follows:]

PREPARED STATEMENT OF MINER H. WARNER, VICE PRESIDENT AND MANAGER, GOVERNMENT FINANCE GROUP, SALOMON BROTHERS, INC.

1. INTRODUCTION

My name is Miner H. Warner, and I am Vice President and Manager of the Government Finance Group at Salomon Brothers Inc. On behalf of Salomon, I have been involved with U.S. government agency and guarantee programs since 1971. I have worked on recourse loan sales such as Farmers Home Administration Insured Block Note and Certificate of Beneficial Ownership sales. In addition, I have had experience with the introduction of new guaranteed securities to the market place such as the $1.2 billion Chrysler guaranteed note sales in 1980 and 1981. Salomon is lead manager for the HUD Section 108 Community Development Block Grant notes which will be introduced in 1987.

Salomon Brothers has been in the vanguard of government asset sales. We are a co-lead manager of the Conrail offering. We have just been appointed as co-lead manager of the $1 billion Farmers Home Administration nonrecourse sale of its community development loan portfolio.

I am pleased to have this opportunity, Mr. Chairman, to appear before your committee to discuss loan asset sales and the experience we have gained to date.

2. GENERAL

Much of corporate America in recent years has developed experience with loan asset sales, including industrial corporations, banks, thrifts, finance companies, insurance companies, pension funds, and homebuilders. Reasons for such structured loan sales include: maximizing profits; minimizing capital requirements; redeployment of assets and liabilities; and tax considerations.

These reasons have led to a vast market for structured and securitized loan asset debt that has reached the $540 billion level. Collateral for such debt includes residential and commercial mortgages, receivables for cars and credit cards, and a variety of other collateral-backed asset financing. By embarking on loan sales, the Administration and Congress are entering large, well-established, and receptive markets. Asset sales, both physical and financial, are standard practice for both private corporations and other nations in the Western world.

3. GOVERNMENT LOAN ASSET SALES

Last year, Congress mandated substantial loan sales commencing in fiscal year 1987 through the Omnibus Budget Reconciliation Act and amendments to the Higher Education Act. The major loan portfolios mandated for sale by

Congress are: Farmers Home Administration Community Development and Rural Housing; Export-Import Bank of the United States; and Department of Education College Housing. Attached to my testimony is a report which we at Salomon Brothers prepared to summarize the 1987 asset sale program. The report is entitled Federal Asset Sales: A New Twist in Deficit Reduction.

Regulatory guidance for loan asset sales have been provided by the OMB Loan Sale Guidelines dated July 8, 1986. In our view, the Guidelines establish a realistic and workable framework within which the agencies can carry out these loan sales. These guidelines have been supplemented by the testimony of S.E.C. Chairman Shad on February 19, 1987 before the Senate Budget Committee addressing the legal implementation of this Administration and Congressional initiative.

Loan asset sales are intended to achieve several benefits, including:

(1) dollar-for-dollar deficit reduction;

(2) diminished use of federal credit;

(3) improved loan administration procedures, including both origination and servicing; and

(4) more accurate measurement of taxpayer subsidies being provided through various federal loan programs.

In testimony given before the Senate Governmental Affairs Committee on May 13, 1986, the first testimony from Wall Street on loan asset sales, I concluded as follows:

1. In order to maximize value it will be necessary to sell creditworthy loans on an individual program by program basis. Loans originated under different programs and different agencies cannot be mixed together.

2. Agencies which administer the loan program, not Treasury, should have primary responsibility for the sales because of programmatic expertise.

3. Loans must be packaged and not sold individually. The negotiated sale method, not the auction method, will maximize value to the government. As a general rule only structured financings will be able to obtain investment grade ratings. Without structuring and ratings, packages of loan assets, despite underlying creditworthiness, will be accorded junk bond treatment and be sold at fire sale prices.

4. Third party servicing is available for creditworthy loans.

The early experience in 1987 loan sales suggests that these conclusions remain valid.

Let me summarize that experience to date. First, through the issuance of requests for proposals, or RFP's, financial advisors have been selected for both of the Farmers Home loan sales and for the Department of Education loan sale. Export-Import Bank has issued an RFP for financial advisor and is expected to make a selection soon. The response from Wall Street for financial advisory work has been vigorous and the level of competition has been high. Second, as noted above, Farmers Home has selected its managing underwriters for its first loan sale. Underwriters are expected to be selected for the other three loan sales during the next several months, based on current indications. Once again, the Wall Street response has been enthusiastic, with numerous national and regional firms competing or preparing to compete for the underwriting business. Third, the first loan sale -- the Farmers Home Community Development loan portfolio -- is scheduled to actually reach the market during the next few months. From all indications, that sale can be carried out successfully and in a manner that accomplishes the intended objectives of loan asset sales. In sum, the loan asset sale program is proceeding in a logical and orderly fashion and has evoked a strong competitive response from the securities industry,

all of which should help to assure maximum return to the federal government.

4. THE NONRECOURSE QUESTION

As you probably know, the OMB Guidelines mandate the sale of all loan assets on a nonrecourse basis, that is, without any continuing guarantee or other obligation on the part of the federal government. In our view, while many tens of billions of dollars of loan assets can be sold without recourse on favorable terms, there are certain loan portfolios held by the federal government which, if sold on a nonrecourse basis, will not attract an acceptable price. There are three key characteristics of such portfolios. The first is a high default rate, which is a strong indicator of poor underlying credit quality. The second is inadequate loan documentation. The private market will require loan documentation that meets normal commercial standards to provide assurance that remedies can be effectively pursued against defaulting borrowers. The third is an agency policy of forbearance with respect to delinquent borrowers. Some agencies act as benign lenders by extending payment terms or granting a moratorium on payments for a period of time. Such forbearance often furthers the original public policy intention of the loan program in question, and many borrowers have justifiably come to expect such favorable treatment based on prior agency actions. A sale of such

loans to a private investor that did not exercise such forbearance could radically increase the stated default rate of the portfolio as well as substantially alter the rights and obligations of the borrowers.

In the case of portfolios that have some or all of the characteristics described above, sale on a full recourse or limited recourse basis may offer certain advantages to the federal government, the most important of which would be the receipt of the full value of the portfolio in the form of a dramatically increased sale price. It is a truism that maximum loan sale proceeds will always be obtained through recourse rather than nonrecourse sales, because the U.S. government assumes all credit risks in a recourse sale. In addition, the sale may be accomplished without the necessity of obtaining a credit rating. On the other hand, a full recourse sale does not accomplish the goal of providing for better loan management nor does it permit a clear measurement of program costs. Further, as noted in the GAO report, recourse sales present practical questions regarding the appropriate scoring for deficit reduction purposes -- while it is clear that nonrecourse sales provide dollar-for-dollar deficit reduction, full recourse and limited recourse sales will not provide any deficit reduction unless there is an alteration in the manner in which OMB scores such sales for budget purposes.

5. THE SMALL BUSINESS ADMINISTRATION PORTFOLIOS

At the present time, we do not have enough facts regarding the SBA Disaster Loan Fund and Business Loan and Investment Fund portfolios to make an informed credit judgment. It is clear that these portfolios, to some extent, have the characteristics noted above. By definition, the SBA Disaster Loan Program provides loans to borrowers that cannot obtain credit elsewhere, suggesting that the overall credit quality of the loans may not be high. In addition, SBA follows a policy in some cases of providing assistance to borrowers experiencing financial difficulties. The use of an SBA guarantee in connection with the sale of these portfolios would overcome these problems and provide the maximum possible price to the federal government. However, until SBA selects a financial advisor and until that financial advisor prepares a thorough analysis of the portfolio, it would be premature to conclude that these particular portfolios require government recourse in order to accomplish a successful sale.

6. CONCLUSION

In conclusion, Mr. Chairman, the loan asset sale program is off to a good start. The total planned asset sales represent only a modest incremental increase relative to existing markets, and we believe that properly structured

and rated loan asset sales will be well-received by investors in high-quality debt instruments. Further, Wall Street response has been vigorous and highly competitive, thereby helping to assume maximum return to the federal government for the loan assets being sold.

Bond Market Research

U.S. Budget Update

November 28, 1986

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Federal Asset Sales: A New Twist in Deficit Reduction

Summary and Conclusions

Congress has recently enacted legislation authorizing the sale of Federal assets, including the Government's interest in Conrail and a variety of Federal loans.

- Asset sales reflect an effort to resolve the ongoing conflict between the perceived need to narrow the Federal deficit and the reluctance to raise taxes or reduce spending. Although the asset disposals will shrink the budget shortfall in the year of sale, the effect will likely be reversed in subsequent years. To sustain the deficit at the slimmer 1987 level, additional asset sales may be arranged in future years.

- It is likely that loans will be brought to market as high investment-grade issues by virtue of packaging, rating, registration, and credit enhancement.

- The long maturities and low interest rates that some of these loans carry will require that they be brought to market at sizable discounts from face value. In addition, because all of the loans are to be sold without recourse to the Federal Government, investors may require compensation for the risk and, initially, for the unfamiliarity of these loans.

- These asset sales will not reduce Federal demands on the credit market. Offerings of Treasury securities will be lowered during fiscal 1987 by the amount of the sales, but that issuance will resurface in alternate credit markets as the loans and properties are sold.

- In addition to providing short-term income for the Government, asset sales will furnish insights into the operation of Government loan programs. An accurate assessment will become available of the sometimes high delinquency and nonpayment rates of the programs, and the degree of subsidy inherent in some loans will be clarified. Furthermore, management and the servicing of the loans may become more efficient as ownership is transferred to the private sector.

For Sale: Conrail . . .

Congress has recently authorized the sale of nearly $7 billion in Federal assets during fiscal 1987. The sale of Federal assets is not unprecedented: The Veterans Administration, the Farmers Home Administration and the Export-Import Bank have sold loans to the public. But the scope of the new sales is considerably greater.

The authors wish to thank William Boyce for his helpful comments.

Figure 1. Conrail — Net Income and Federal Support, Calendar Years 1976-85 (Current Dollars in Millions)

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Federal Support	$551	$794	$847	$834	$555	$2,340	$770	$191	$25	$20
Net Income	(246)	(412)	(430)	(221)	(244)	39	174	313	500	442

Source: Congressional Budget Office

The largest asset slated for sale is the Federal Government's 85% ownership in the Consolidated Rail Corporation (Conrail). Established as a private corporation comprising the track systems of various bankrupt railroads, Conrail was created to sustain rail transport lines that Congress considered essential. In its first six years of operation, 1976-81, despite large infusions of Federal funds, Conrail steadily lost money — a total of $1.5 billion. Partial deregulation of rail transport rates and other measures enacted by Congress in 1980 made Conrail profitable by 1981 (see Figure 1), but over the years, Congress has contributed more than $10 billion in 1985 dollars to turning Conrail into a viable operation.[1]

Congress will dispose of its share of Conrail via a public offering. A target price of $1.7 billion has been set for the sale; a transfer of up to $300 million of Conrail's cash reserves to the Federal Government and tax revenues derived from a lump sum labor payment will yield an additional $400 million in receipts for the Government.

It is still unclear if Congress will obtain its target price. Conrail has been profitable for almost five years and has assets of nearly $3 billion. But the tax treatment of Conrail after its sale will be less advantageous than hoped: Previously accumulated net operating losses will not be carried forward, and Conrail's asset base will be determined at the time of sale, limiting future tax benefits for the newly privatized enterprise. Furthermore, an effort to partly reverse the railroad deregulation enacted in 1980 has recently gained support in Congress, spurring concern that Conrail's future earning capacity may be curtailed. Finally, economic strength, in general, and the equity market, in particular, will affect the stock sale's yield when the shares are brought to market.

The Conrail sale mirrors moves in other major industrial nations — including the United Kingdom and France — toward privatization of Government-owned enterprises. In addition, it conforms to an ultimatum issued by Congress in 1981 that Conrail be returned to the private sector — either as a profitable enterprise or piecemeal to the highest bidder.

. . . And Assorted Loans

The other asset sales that Congress contemplates may contribute somewhat less to privatization than will Conrail's disposition. Although a large volume of Federal loans — enough to yield nearly $5 billion in the current fiscal year — may be sold to the private sector, Congress has not transferred the origination function underlying these loans to the private sector: Only the ownership and servicing of existing loans will leave the public sector.

This shift will yield some of the benefits of privatization. Private loan servicing will likely be more cost efficient than public servicing has proven. In addition, the loan sales will clarify the degree of subsidy inherent in many loan programs by revealing the delinquency and nonpayment rates of each program. Nonetheless, as long as Congress retains loan origination within the Federal realm, a primary motivation behind these sales seems to be a desire to reduce the Federal deficit without raising taxes or reducing spending — not privatization.

[1] *The Economic Viability of Conrail*, Congressional Budget Office.

Figure 2. Federal Loans Designated for Sale or Refinancing, by Program (Dollars in Billions)

Program	Planned Loan Proceeds	Total Portfolio of Loans	Typical Loan Rate	Loan Description
Eximbank	$1.5	$16.0	7.5%	Loans made by the Export-Import Bank to foreign importers
RDIF	1.0	8.0	5	Loans made by the Rural Development Insurance Fund to rural municipalities to finance water systems and other community facilities
College Housing	0.6	2.6	3	Loans to colleges and universities to fund the construction of dormitories and other educational facilities
Rural Housing	1.7	22.0	Various	Single-family rural home mortgages issued by Farmers Home Administration through the Rural Housing Insurance Fund
Rural Electric	2.0	20.0	Various	Allows rural electric co-ops to prepay and refinance outstanding loans with high interest rates

RDIF Rural Development Insurance Fund

Recently enacted legislation has authorized the sale or refinancing of loans created under five separate programs. These are summarized in Figure 2.

- **Export-Import Bank Loans.** These subsidized loans to foreign importers are designed to facilitate the purchase of U.S.-manufactured goods. Established to promote U.S. export sales, the program has become increasingly important as a means to match the terms offered by other nations' export credit programs. The quality and default rates of these loans vary widely: Recipients range from creditworthy nations to high-risk developing countries. Collateral is sometimes, but not always, provided. The loans carry interest rates as high as 12%, but most are nearer to 7.0%-7.5%. Consequently, prepayment, which is permissible in most of these loan programs, must be considered a risk.

- **Rural Development Insurance Fund Loans.** At least $1 billion is to be raised by selling loans made by the Rural Development Insurance Fund (RDIF). Carrying coupons close to 5%, these loans have been issued to rural municipalities to fund the construction of water systems, waste disposal facilities and community facilities in rural areas. Interest and principal payments have been funded through the issuance of municipal bonds; consequently, delinquency and default have not presented a serious problem. Furthermore, income generated by these loan sales after sale to private investors could theoretically be deemed tax-exempt at the Federal level. However, the Administration now appears inclined to rule that the loan income be treated as fully taxable.

- **College Housing Loans.** These direct loans are offered to colleges and universities to fund construction, renovation or the acquisition of student and faculty housing. Loans carry interest rates of 2.75%-3.00% and original maturities of up to 30 years. Collateral for the loans consists of mortgages on the buildings funded in the case of private institutions and of tax-exempt bond issues in the case of public institutions. As is true of the RDIF loans, this tax-exempt status will probably not be passed through to the loans when sold.

- **Rural Housing Insurance Fund**. These loans represent mortgages issued by the Farmers Home Administration on single-family rural homes. Coupons vary widely; recently, mortgages have generally been granted at rates slightly above the Federal Government's cost of borrowing. Although delinquency has been frequent in this loan program, administrators have shown extraordinary forbearance.

• **Rural Electrification Loans.** These Federally guaranteed loans carry rates above the current cost of private funds to rural electric co-ops, and, in general, cannot be refinanced without a substantial prepayment penalty. Congress has agreed to waive the penalty for a limited volume of loans. These loans will be prepaid and refinanced in the private sector — not offered as a nonrecourse asset sale; however, the effect on the Federal deficit and on credit demands is comparable with that of the loan sales now planned.

The Budgetary Impact of Asset Sales

An effort to shrink the Federal deficit to meet the constraints set by the Gramm-Rudman-Hollings (GRH) budget-balancing legislation figured importantly in this year's approval of Federal loan sales and likely added a needed spur to the sale of Conrail — an undertaking that had been contemplated for several years. The proceeds from asset sales will undoubtedly narrow the deficit in the year in which loans are brought to market.

Whether asset sales reduce the deficit long term is another question. At the time of sale, the Government will receive each asset's present value — as determined by the marketplace. That return will be implicitly invested by the Federal Government at the Treasury's average cost of financing, because it will reduce the amount of Treasury borrowing in the year of the sale. Thus, in future years, Federal outlays will be lowered by the amount of interest saved and any future loan defaults; personnel and support costs will decline as well. However, net outlays also will be enlarged by the amount of loan income and repayments now forgone. Nonetheless, it is doubtful that over the long haul, the Government will achieve savings. That is because the market is likely to discount the loan income stream at a rate above the Treasury's cost of financing.

A Short-Term Impact on the Deficit

Indeed, generally, lower loan income will outweigh interest savings almost immediately. This would not necessarily be true if the Government were selling interest-only loans. In that case, for certain combinations of loan rates and maturities, the Government might be better off each year until the principal fell due. However, the loans set for sale are all self-amortizing to some extent, and some carry low interest rates. Interest savings will never exceed forgone loan receipts after the sale of a below-market-rate mortgage. Consequently, in the years following a loan sale, the deficit will generally be higher than would otherwise have been the case — unless new asset sales are undertaken each year. The Congressional Budget Office has estimated that the deficit will be hiked by about $1 billion in fiscal 1988, if the full complement of asset sales now planned for 1987 comes to market.

Although asset sales will not permanently trim the Federal deficit, other benefits will result. Management and the servicing of the loans will likely become more efficient as loan administration is transferred to the private sector. Nonpayment rates could improve. In addition, the prices at which assets are sold will clarify the exact degree of subsidy inherent in each loan program. In fact, if new loans were sold as soon as they are originated — a possibility that has been discussed — the subsidy inherent in the program would become clear and would have to be paid explicitly as loans were issued. As currently structured, the implicit subsidy is buried in generally higher Treasury financing costs and in delinquencies and defaults that occur years after the loan is issued.

Revealing the subsidy is not the main objective of loan sales, however, but an attractive side effect. The major motivation for loan sales seems to be to

reduce the deficit as noncontroversially as possible. Disposing of assets is less likely to antagonize voters than the alternatives would – raising taxes or cutting spending. Consequently, although loan sales only temporarily suppress the deficit, it would not be surprising if Congress planned additional sales in the year ahead.

Loan sales cannot provide a permanent solution to the budget deficit, however. Even in the unlikely circumstance that the Government is able to sell its entire loan portfolio, which is estimated to exceed $250 billion, at face value, the proceeds would offset scarcely more than a single year's deficit. In addition, the interest savings of $15-20 billion would just dent the underlying budget deficit, which will likely exceed $170 billion in fiscal 1988.

Implications for Treasury Financing

Although Treasury debt issuance will be reduced in the year of the asset sales, Federal demands on credit markets will not be lowered. Instead, the borrowing will be redirected to alternate sectors of the credit market. About $1.7 billion will resurface in the equity market as Conrail is sold. The balance, currently estimated at about $6-7 billion, will reappear as competition for corporate and municipal issuance. Given the relatively small total issuance involved in these sales, however, it is unlikely that asset sales will perceptibly affect the relative values of Treasury securities.

The Mechanics of Loan Sales

Even before Congress granted final authorization of the proposed loan sales, an effort to develop an effective method of implementing the sales had already begun. The Office of Management and Budget (OMB) issued broad guidelines about the conduct of loan sales in July. Nonetheless, it must yet be determined exactly which loans can be sold, in what form, when, and at what price.

(1) Two considerations will likely determine *which* among the designated loans will ultimately be sold: credit quality and the availability of documentation. The highest-quality loans will be the most welcome in the capital markets and provide the largest return for the Government. Equally important, however, will be proper documentation. In some instances, Federal agencies have been lax in maintaining loan records; it will be impossible to sell loans without sound supporting legal documents. Presumably, however, this problem can be resolved with some effort on the part of the relevant agencies.

(2) The *form* of the loan sales has not yet been chosen. However, the OMB guidelines specify the following: The loans will be sold without future recourse to the Federal Government; servicing of the loans will be transferred at sale; each issuing agency will oversee sales from its portfolio; and sales will be conducted on a competitive-bid or negotiated basis. Given the small size and variable quality of the loans in each program, successful disposition of the loans will require that they be packaged, not sold individually. Credit enhancement, registration and rating of the packaged securities by independent agencies will further augment the likely yield of the sales. Standardization of all new loans within these programs would facilitate any future asset sales.

(3) It is not clear *when* the sales will occur. Sales will likely be spread throughout fiscal 1987, with the first offering as early as January. Many more are currently targeted for early next year. There is a minor risk that some modest portion of the sales might be deferred, because the GRH budget-balancing procedure could influence the final timing of loan sales. When Congress recessed in October, fiscal 1987 was a closed issue as far as

GRH is concerned; the focus is now on fiscal 1988. With the gap between the GRH 1988 target and the underlying deficit exceeding $60 billion, there may be an incentive to defer some asset sales planned for 1987 into the following year.

(4) The *price* of the securities will be determined by the same factors that influence private offerings.

Prevailing interest rates and *loan maturities* will play the key role in assessing the market value of the loans. The price paid for the loans must compensate for the sometimes large gap between market interest rates and the subsidized rates attached to many loans. It must also reflect the maturity of the loans, which often stretches to 30 years. Consequently, the dollar price of these securities will often be low relative to face value.

The *risk* of each program as reflected in its repayment history will also materially influence the offering price. A premium will be required to compensate for loans that will fall into arrears or never be collected. In certain programs, this has not been infrequent. Federal loan administrators have often been considerably lenient toward late or absent payment: Interest payments have been deferred for long periods, and loan rates on occasion have been renegotiated to a lower level. Private investors will not likely emulate this behavior. The extent of such forbearance in the past will undoubtedly become evident, as assets are brought to market and clearly reflected in the rating assigned to each sale.

An *uncertainty premium* may be required in light of investors' unfamiliarity with the loans due to be sold. However, this will likely dwindle as investors are increasingly familiarized with the loans slated for sale through the marketing programs of the institutions managing the sales.

A *liquidity premium* may also be assessed. If sales were held to the $100-million minimum designated in the OMB guidelines, this premium might be sizable. However, the total volume of loans anticipated for each program — $0.6-1.7 billion — appears adequate to ultimately provide liquidity on par with most corporate issuance. Further, should the Federal Government expand the scope of loan sales in the future as now appears likely, any liquidity premium would be further reduced.

The cumulative effect of these factors will vary considerably among the loans to be sold. It is probable, however, that the loans to be sold first will be of relatively high quality and, as such, will likely earn a high investment-grade rating and carry risk and liquidity premiums not unlike those of high-grade corporate bonds. For example, Rural Development Insurance Fund loans with long maturities, if optimally structured, may come to market with a spread of about 100-150 basis points over the comparable Treasury issue.

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Chairman LAFALCE. Mr. Blume.

TESTIMONY OF LAWRENCE J. BLUME, VICE PRESIDENT, GOVERNMENT GUARANTEED FINANCIAL DEPARTMENT, MERRILL LYNCH CAPITAL MARKETS

Mr. BLUME. My name is Larry Blume. I am the vice president of Merrill Lynch, located in Washington, DC. I have been with Merrill Lynch for 5 years. My responsibility is all U.S. Government guaranteed programs and our investment banking relationships with the various Federal agencies and federally sponsored agencies.

Chairman LAFALCE. You say you are located in Washington, DC. Are you a Government representative?

Mr. BLUME. No; I am an investment banker.

Chairman LAFALCE. What is John Heimann's position with Capital Markets?

Mr. BLUME. He is the vice chairman of Merrill Lynch Capital Markets.

Chairman LAFALCE. Vice chairman. All right.

Mr. BLUME. Prior to joining Merrill Lynch I was with the U.S. Treasury Department. And among the other positions I held there was legal counsel and manager of the Federal Financing Bank, which as you probably know, finances many Government guaranteed programs, including several at SBA.

I am happy to be here today to help you consider the President's 1988 budget proposals. In my statement, which I will summarize here, I would like to address the specific points which you raised in your invitation to me to testify.

The first point I would like to cover is the Loan Sale Pilot Program which the President proposed. Basically, it is having the U.S. Government agencies sell, out of their existing portfolios, loans without recourse. The stated purpose of this program is twofold: Reduced budget deficits and improved program management.

We, at Merrill Lynch, generally support both of those objectives. But I wanted to raise a couple of points. With respect to reducing the deficit, I think it is fairly obvious that just selling loan assets, is only a short-term solution to the budget problem. If loan programs remain at current levels, future year deficits will increase because of the revenues forgone through asset sales.

Chairman LAFALCE. I do not know if you were aware of the testimony that Joe Wright, OMB Deputy Director, gave on Tuesday when he said we are not going into this in order to reduce the deficit. This is in order to improve our credit reform management techniques. He proferred that we might want to use the sale of assets to retire debt as opposed to reducing the deficit. But, of course, you have totally different purposes in how you structure something dependent upon the goal you want to achieve.

Mr. BLUME. I think that is right. The other objective is to improve program management. And if you are looking solely at the pilot program, we wonder whether there will be a significant impact on new loan underwriting standards merely by the sale of old loans.

I think that for program management to be improved you probably have to look at the second piece of the President's proposal, credit reform, which I will cover in a minute.

With regard to Merrill Lynch's involvement in the pilot program to date, as you know, there have been no loans sold under the pilot program. Several financial advisors have been selected. Merrill Lynch, to date, has not sought to be selected as a financial advisor for those programs because we want to be the underwriter on those programs, and we would not be eligible if we were the financial advisor.

Chairman LAFALCE. More money in underwriting than in advising.

Mr. BLUME. That is very true. We have applied to be the advisor for the SBA portfolio sale for several reasons. One is that we are very familiar with SBA and have supported them over the years. And second, we thought that while, in general, we would rather be an underwriter, we thought we would like to be a financial advisor for one of these programs.

With regard to the Farmers Home Community Development Loan Program, which has gotten farthest along in the process, we were selected as a comanager of the underwriting group just recently.

Chairman LAFALCE. And who is the other?

Mr. BLUME. It is a group which, I believe, includes Salomon Brothers, Shearson, Merrill Lynch, Bear Stearns, Goldman Sachs, and Morgan Stanley.

The second portion of the President's 1988 budget proposal is credit reform. And as I understand the proposal, it would be as follows: Direct loans as made would be immediately resold and the difference between the base amount of the loan and the proceeds would show up as an outlay, rather than the current treatment where the entire amount of the direct loan shows up in outlay.

With regard to guaranteed programs, the guaranteed loans would be reinsured with private insurance and the difference between the guarantee fee charged the borrower and the cost of the private insurance would show up as an outlay.

While I am not an expert on Federal budget concepts, I would suggest a couple of things. First, there has been a lot of discussion about the problems with the Federal budget, and there are problems with it. However, the Federal Government currently has what we in the private sector call a sources and uses, or a cash-flow statement. If that is, in effect, what the Government wants the budget to be, I think that the current treatment of guaranteed loans and direct loans is appropriate. The real issue is whether the Government wants to keep track of and make a distinction between current and capital expenditures. The way to do that is not in a cash-flow statement, but in some form of income statement and balance sheet.

Chairman LAFALCE. We do not have a balance sheet in the Federal Government.

Mr. BLUME. That is right.

The second point I would raise with this new credit reform is that it assumes, incorrectly I think, that in trying to measure the size of the subsidy, it is the value of the subsidy to the borrower

rather than the cost of the subsidy to the Government. I would suggest that perhaps measuring the cost to the Government rather than the benefit to the borrower is the better measure of that subsidy.

Third, and I think this is a fairly minor point but something to be brought out, that with changes in interest rates the value of a loan, even on a guaranteed basis, can change radically over a very short period of time. Therefore, if you make this loan on day 1 and you sell it on day 10, the difference in price between those may reflect not only the credit problems with the borrower, but it also reflects changes in interest rates over that period of time, which are not a part of the subsidy.

The next issue is the OMB guidelines, which they issued to cover the pilot program. I would like to raise a couple of points, the first being sales with recourse versus nonrecourse sales.

I think it is fairly clear that if the Government really wants to sell these assets, then it should sell them without recourse. I think it can be correctly argued that if you sell loans with a full guarantee, you have not sold the asset. Rather, you have just borrowed some money, albeit fairly expensively. If you are selling loans without any recourse at all, I think there are a couple of things the Government ought to keep in mind.

The first one is that the value which you will receive for these assets, regardless of how well the financing is structured, will not equal the value to the Government of the stream of payments from those assets which the Government would receive if it continued to hold the assets. I think there are two reasons for that.

One is that any investor who purchases the assets is going to seek a yield which is higher than the Government's borrowing cost. The higher the yield, the lower the net proceeds. The second point is that, at least with initial sales, investors will be unfamiliar with the default rate on the assets that they are buying. If they are unfamiliar with these default rates they will naturally assume higher default rates. To the extent that those default rates are lower than what was assumed by the investor, that is a value which the investor receives and the Government will have foregone. I think a way of solving this second is to structure the financing so that there is a subordinated interest in the assets which the Government could continue to hold until the default rate became clear, and then perhaps resell that subordinated interest when it would have some value.

Chairman LAFALCE. Is that another way of defining partial recourse? Or is that different?

Mr. BLUME. It is basically, overcollateralization, and selling that overcollateralization at a later date when its value becomes clear. It could be considered partial recourse. The idea would be though, that rather than a partial guarantee you are overcollateralizing a sale and later selling overcollateralization after the market recognizes that it has value.

Chairman LAFALCE. Have you, Mr. Blume, communicated with OMB regarding the desirability of changes in the guidelines? Both of you have said basically, the same thing in different ways.

Mr. BLUME. Not with OMB, but we have discussed this idea with Farmers Home, who has gone farthest along in the program.

Chairman LAFALCE. I should not interrupt you. Go ahead.

Mr. BLUME. And the final point on that is that the OMB guidelines would apparently preclude that type of retention of subordinated interest.

The second point I would like to raise with the OMB guidelines is the point that you touched on earlier. That is that the guidelines preclude the Government's financial advisors from acting as underwriter, underwriting the sale of the loan.

Chairman LAFALCE. I am not too familiar with your terminology. So could you tell me the difference before you proceed between underwriting, and placing, and selling?

Mr. BLUME. When you underwrite, you actually buy the loans with the idea of reselling them immediately. When you act as a placement agent you never hold title to the loan. You just put the buyer and seller together.

Chairman LAFALCE. What are you really being called to do under these guidelines? Underwrite or place?

Mr. BLUME. It will depend on how each individual finance is structured. If they are structured and sold in pools and what you will be selling is either interest in those pools or debt secured by those pools, then you will be selling securities. I think that most of those would be on an underwritten basis. That is, the underwriting group will buy those securities and then turn around and resell them.

With some of these portfolios, you may find investors who are willing to buy individual loans. In that case, either the advisor or somebody that the advisor hires will actually find those investors and act as a placement agent. But I think in general, the sales are going to be underwritten offerings.

On the point about the advisor not being the underwriter, there are a couple of points to be made. The first one is that it is a common practice in the corporate and the Federal sponsored agency market for underwritten deals, that the issuer will review proposals from various underwriters, see which of them is the best qualified and has the best structuring ideas, and then select that group and work with that group to develop the structure.

What has been happening in the pilot sale is that you have the first phase agency pick the advisor. The best qualified dealers are not interested in being the advisor because they cannot also act as underwriters. Then you must select, as an underwriter, a second selection process. The agencies probably are not getting the best advice early in the process, because you really cannot structure a sale until you have the underwriters on board who are going to have to actually buy and market the loans.

Finally, I would like to turn to the GAO report. I really only have one comment. I think the main thrust of the GAO report was that it criticized the OMB guidelines for precluding partial recourse. I agree with GAO that sharing of risk between investors and the Government, that is, partial recourse, is desirable. But having worked in the Government and also on Wall Street, I think the Government should keep in mind that sometimes partial recourse, if artfully structured, in effect, can be full recourse. I do not want to bore you with details, but I think it is imperative for the

Government to recognize when the investor has a credit risk and when he has none.

Finally, you asked me to describe, the effects of asset sales on the borrowers. In general, if the loans are sold with recourse the effect on the borrower should be minimal, the reason being that the credit risk remains with the Government and any collection, acceleration, or default actions will be begun by the Government as they are when the Government holds the loan.

If the loans, however, are sold without recourse, I think you can expect the borrowers will see less forbearance from private investors, especially in cases where the interest rate on the loan is very low relative to current markets and where the collateral securing the loan exceeds the principal outstanding on the loan.

That concludes my remarks.

Chairman LAFALCE. Thank you, Mr. Blume.

[Mr. Blume's prepared statement follows:]

Prepared Statement of Lawrence J. Blume, Vice President, Government Guaranteed Financial Department, Merrill Lynch Capital Markets

Chairman LaFalce and Members of the Committee: My name is Lawrence Blume. I am a Vice President of Merrill Lynch Capital Markets. I am located in Washington, D.C. and am responsible for Merrill Lynch's participation in all U.S. Government guaranteed programs and its investment banking relationships with Federal agencies and the so-called Federally "sponsored agencies". Prior to joining Merrill Lynch in 1981, I worked for eight years in the U.S. Department of the Treasury, serving in the Office of the General Counsel and later in the Office of Domestic Finance. I also acted as Legal Counsel to, and later Manager of, the Federal Financing Bank, which finances many U.S. Government agencies and guarantee programs - including those of the SBA.

I am pleased to be here today to help you consider the President's Fy 1988 Budget proposals for Federal loan asset sales. In my opening statement I will briefly respond to the questions you raised in your March 4 invitation to testify.

Loan sale pilot program. Simply stated, the program contemplates that agencies will sell, without recourse, direct loans out of their existing loan portfolios. The stated purposes of the program is to improve program management and reduce budget deficits. Merrill Lynch has generally supported efforts by the President and Congress to improve the management of Federal credit programs and reduce the deficit. As one of the leading investment bankers and securities dealers in the U.S., we also expect to participate in all Federal asset sales. I would, however, like to make the following observations regarding the objectives of the program.

- Reduce the deficit. Loan asset sales are only a short term solution to budget deficits. At constant program levels, out year net outlays will increase due to the forgone revenues resulting from asset sales.

- Improve program management. Merely selling old loans out of an agency's portfolio will not substantially impact the standards used to originate new loans. For there to be any real impact on agency management practices, the other part of the President's proposal, which contemplates reselling loans as they are made, would also have to be adopted.

Merrill Lynch's involvement. To date, no loans have been sold under the pilot program. Financial advisors have been selected by the Farmers Home Administration and the Department of Education. Merrill Lynch did not seek to be selected as the advisor to these agencies since under OMB's guidelines a financial advisor is not eligible to underwrite loan sales. We decided that Merrill Lynch would be better qualified to act as an underwriter.

Of all the agencies' efforts, the Farmers Home Administration Community Development Loan Program has made the most progress. Recently a management group for an underwritten, negotiated public offering was announced. Merrill Lynch was selected as a comanager in that group.

Credit reform. The President's Fy 1988 budget also proposes to resell, without recourse, direct loans as they are made, and reinsure Federally guaranteed loans with private insurance. Budget outlays would equal: for direct loans, the difference between the face amount of the loan and the net proceeds from the sale; for guaranteed loans, the difference between the guarantee fees collected and the cost of re-insurance. The purpose of this proposed change from current budget concepts is, as we understand it, to better reflect the timing and size of the subsidy inherent in any Federal credit assistance. While I am not an expert on Federal budget concepts, I would point out the following:

- The Federal budget is basically an annual cash flow statement. In that sense, the current treatment of direct and guaranteed loans is reasonable. If the Government sees a need to measure the difference between current and capital expenditures, it may wish to consider adopting the balance sheet and income statement format used by private corporations.

- The proposed scoring for direct loans incorrectly, in my judgement, assumes that the proper measurement of the subsidy is the value of the assistance to the borrower rather than the cost of the assistance to the Government.

- Changes in interest rates between the time the loan is made and the time the loan is sold could overstate or understate the size of the subsidy.

OMB Guidelines. I have several comments on the guidelines developed in July, 1986 by the Federal Credit Working Group to guide individual agencies in their implementation of the loan sale pilot program.

- Recourse vs Non Recourse. If the purpose of the sales is really to dispose of loan assets rather than to merely reduce current budget outlays, it is perfectly logical to sell the loans without a guarantee by the Federal Government. Otherwise, the sale could be considered, in effect, not a sale at all, but rather a costly form of Government borrowing. It should be recognized, however, that the proceeds to the Government from a non-recourse sale will likely be less than the value to the Government of the future stream of payments from those assets. There are two reasons for this.

  -The U.S. Treasury's borrowing costs are lower than a private investor's required rate of return; thus a private investor will need to use a higher rate to discount the future estimated payment stream on the assets; the higher the discount rate, the lower the net proceeds.

-At least for initial sales, private investors, being unfamiliar with the assets, will tend to overestimate the credit risk and assume higher default and lower collateral recovery rates than will actually occur. This will reduce their estimate of the future payment stream from the assets and the price they are willing to pay for that stream.

This second problem can be addressed by structuring the sale so that the Government retains a subordinated interest in the assets, which can be resold for value at some future time when the real default risks are better recognized by investors. However, this structure appears to be prohibited by the guidelines.

- o Advisor vs Underwriter. The guidelines prohibit an agency's financial advisor from underwriting any loan sales. It is common for corporate and Federally sponsored agency issuers to review proposals from potential underwriters, select those which are the best qualified and have the best structuring ideas, and then work with those underwriters to structure and market their issue. The best advisor to an agency for these loan sales will come from the small group of investment banks who regularly structure, lead manage, and trade mortgage and other asset-backed securities. However, these investment banks, including Merrill Lynch, have generally chosen not to act as financial advisor. They would rather participate in the underwriting. The effect of this restriction in the guidelines is to deny the agency of the best advice early in the process, and to prolong the process since no real structuring of a sale can begin until the underwriters have been selected. Consideration should be given to allowing an agency to select an advisor to advise on the best way to sell the loans, and if that sale involves a public underwritten offering, allow the advisor to manage that offering.

GAO Report. You asked for my reaction to the September 1986 General Accounting Office report entitled "Loan Asset Sales".

The report recommends that the OMB loan sale guidelines allow structured financings, and third party servicing of the loans. It is my understanding that both would be permitted under the existing guidelines.

The report also recommends sales with partial recourse to the Government as a way of maximizing proceeds, and describes a proposed sale of $2.1 billion face amount of college housing loans with a "partial" guarantee by the Department of Education. I did not fully understand the GAO report's description of the proposed transaction or its analysis of the savings to the Government from this transaction as compared to a non-recourse sale. In general, I agree with the idea of risk sharing through partial guarantees. However, having worked on guarantee programs both inside and outside the Government, I think it

is very important for the guaranteeing agency to beware of "partial" guarantees which, through creative structuring, are in effect full guarantees.

Effects on Borrowers. The effect, if any, on a borrower whose loan is sold will depend on how the loan sale is structured. If the sale is with full recourse, the effect on borrowers will be minimal since any default and collateral recovery actions will be taken by the guaranteeing agency which continues to bear the credit risk. If, however, the loan is sold without recourse, a borrower can expect less forbearance when a default occurs, especially where the interest rate on the loan is low and the value of the collateral exceeds the principal amount outstanding on the loan.

This concludes my opening statement. I would be happy to answer any questions you or the members of the committee may have.

Chairman LAFALCE. Our next witness will be Mr. Cooke.

TESTIMONY OF HAROLD E. COOKE, VICE PRESIDENT, MORTGAGE FINANCE DEPARTMENT, THE FIRST BOSTON CORP.

Mr. COOKE. Thank you Mr. Chairman.

My name is Harold Cooke. I am a vice president of The First Boston Corp. I appreciate your invitation today to speak on several important topics. I request that my written testimony be incorporated in full in the record. The two topics I will address in my testimony are the Asset Sale Pilot Programs and the Federal credit reform initiative.

In my opinion, the private capital markets will be very interested and receptive to well-structured and well-timed sales of Government loan assets under the current pilot programs.

The sales can be conducted successfully within the OMB guidelines if those guidelines are applied flexibly. But due to the market's inexperience with Government loan assets on a nonrecourse basis, in my opinion, there will be a high level of conservatism initially. We will see over time that during a transition period, the private capital markets will develop experience with the quality and type of borrowers that are included in these Government programs, and during their transition period, the market will begin to grow more comfortable with, and give greater acceptance to, these loan assets.

As part of that greater acceptance, you should see a greater netting of proceeds to the Federal Government as asset sales roll out during the 1987 pilot program and the proposed 1988 program.

But in making this transition, investors will have to make informed judgments about the risks that they are undertaking in buying these loans and they will have several concerns: First, they will be concerned about the underwriting standards of the applicable agency and whether those underwriting standards have been applied consistently across the board.

Second, investors will be concerned with the type of credit enhancement that will be associated with the loan sales. A third concern will be the quality of the portfolios' documentation. Those are my general observations. I would now like to focus on the market's reactions to the Federal credit working group guidelines.

As you have heard here and in other testimony, the major issues associated with those guidelines from Wall Street's perspective are nonrecourse and transfer of servicing. What will happen in the absence of——

Chairman LAFALCE. Have the other two gentlemen mentioned transfer of servicing, or have I missed it?

Mr. BLUME. I mentioned it in my testimony.

Chairman LAFALCE. I missed it.

Mr. COOKE. In the absence of a full Federal guarantee, you will have one of two results. Either you will have reduced net proceeds or you will have no sales at all. The reason for the reduced net proceeds is because the underwriter will have to seek private sector credit enhancements which have a cost associated with them.

We recognize that this nonrecourse issue is of great concern to you and your colleagues, particularly as it pertains to the protec-

tion of substantial borrowers rights. The real paradox here is how, in the context of trying to develop a public/private partnership to sell these assets, do you reconcile the nonrecourse policy with the protection of substantial borrowers rights?

I would suggest that this can be achieved through selective continuing involvement on the part of certain agencies where appropriate. This selective continuing involvement could occur during a transition period where you are taking assets which were originated in the context of public policy concerns and transfering those assets to the private capital markets whose concerns are more on the commercial side.

With supervised credit programs, which is what we are generally focusing on in this pilot program, transfer of servicing to the private sector could conceivably produce efficiencies, but it also poses problems with respect to borrowers rights issues. I would now like to turn my remarks to the question of the credit reform initiative.

We should view this experience in the context of using the capital markets as a laboratory for experimentation in the various pilot programs and sales. It is my understanding, and the guidelines seem to suggest unequivocally, that the parties involved will have an opportunity from one sale to the next to use different types of approaches.

You asked the question earlier, Mr. Chairman, what is the difference between an underwriting and a private placement. Both of those alternative concepts are set forth in the guidelines as being appropriate means of selling the assets. So we would suggest that using the capital markets as a laboratory will enable you, your colleagues, and others in Washington to think about how, in the context of selling these assets, you can achieve the ends of insuring protection of the borrowers rights, but yet placating concerns of investors that they will have a full and timely return of their invested dollars.

In the context of the credit reform initiative, I believe Wall Street is concerned that there be a sufficient volume of loans and that these loans be sold on a sustained basis so that maximum liquidity, will develop. By maximum liquidity, the pricing or the net proceeds to the Federal Government should improve.

As you know, there is a debate going on concerning whether these sales should be on or off budget for scorekeeping purposes. I would suggest that during this period of transition that there should be a mixed approach. In the context of thinking about preserving borrowers rights and, at the same time, recognizing the importance of Wall Street in making these sales successful, it is important that the market's early conservatism could perhaps be assuaged by the Government's selective continuing involvement. And in that flexible context, this debate of whether the sales are on or off budget, I think, can be discussed in a very, very effective manner.

You have asked us to discuss the implications for the SBA Loan Asset Pilot Program. The SBA's portfolio will be subject to the market concerns over treatment of borrowers rights, underwriting standards, loan documentation, and credit enhancement.

If structured properly and timed properly, the SBA's asset sales need not adversely affect other SBA programs. And the key to suc-

cess is timing and providing adequate information responsive to the market's concerns.

Mr. Chairman, in concluding, I would like to say that in my opinion the investors on Wall Street will have a high level of interest in these proposed sales. We think that with the public/private partnership we can protect and deal with the concerns of Wall Street, the Federal Government, and the constituents of this committee.

Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you.

[Mr. Cooke's prepared statement follows:]

PREPARED STATEMENT OF HAROLD E. COOKE, VICE PRESIDENT, MORTGAGE FINANCE DEPARTMENT, THE FIRST BOSTON CORP.

Good morning Mr. Chairman. My name is Harold E. Cooke. I am a Vice President for Mortgage Finance with The First Boston Corporation and I am responsible for coordination of First Boston's activities with respect to the government's asset-sale pilot program and credit reform initiative. On behalf of First Boston, let me express my appreciation for your invitation to testify on this very important matter of federal asset sales and credit policy reform, a matter which occupies a very high priority and is viewed with great interest at First Boston.

First Boston is a full-service international investment banking firm headquartered in New York City. First Boston's activities cover the complete range of corporate, financial, governmental and agency securities, and the firm is recognized for its leadership and innovation in the specialized area of asset-backed, structured financing. First Boston makes markets and trades in the broadest possible spectrum of asset-backed[1/] products, including securities backed by lease receivables, credit card receivables, automobile receivables, residential and commercial mortgages, and a variety of other financial assets. For these reasons, First Boston has substantial experience with the spectrum of financing issues pertaining to government-related asset sales and we have a strong interest in being involved in the government asset sales conducted under the existing federal pilot program for fiscal years 1987 and 1988.

1/ Debt instruments secured by financial assets which include residential and commercial mortgages, loans, leases or installment contracts.

Obviously, First Boston's views on these matters come from the perspective of Wall Street and the global private capital markets, a constituency whose interest and participation in government asset sales are absolutely vital to the success of that program. The invitation the Committee extended to First Boston and the other financiers on the panel this morning bears witness to your appreciation of our interest and the expertise which we may lend to your deliberations. I hope that the viewpoints First Boston has to offer on the asset-sale pilot program and the broader federal credit policy initiative will be helpful to the Committee's understanding of the needs and concerns of private investors.

I have prepared First Boston's remarks with respect to the various topics which are the subject of today's hearing in the following order of presentation:

- First, our general observations concerning government-related asset sales;
- Second, First Boston's comments with respect to the Guidelines established by the Federal Credit Working Group for the asset sale pilot program;
- Third, First Boston's views regarding the objectives and procedures for the expanded pilot loan asset sales set out in the President's 1988 budget, including the initiative to establish a subsidy cost for new federal loan obligations and guarantee commitments;
- Fourth, what First Boston perceives to be the implications of the asset sale Guidelines and credit reform initiative with respect to the Small Business Administration's asset sales and programs.

A. General observations concerning government-related asset sales.

We fully expect that the private capital markets will be very interested in and receptive to well-structured and well-timed sales of government loan assets of the type included in the current pilot program. Due to the fact that this pilot program involves the sale of loan assets from many government programs with which the private capital markets have little, if any, direct experience, one should expect investors to react cautiously and conservatively to the first such offerings by an agency. The markets are aware that the engine driving many of the agency loan programs has been public policy considerations which do not necessarily comport with the purely commercial lending principles with which the market is quite familiar. The market has substantial, and as yet unresolved questions about the quality of the government portfolios, particularly with regard to such characteristics as underwriting standards, delinquency and default rates, prepayments, and loan documentation, all of which enter into an evaluation of the risk entailed in investing in the government portfolios.

While investor interest likely will be high in a well-conceived and professionally implemented asset-sale program, it is critical to understand that, particularly in these early efforts by the agencies, great care must be taken not to expose the capital markets to substantial losses. Nothing will chill investor confidence and interest in future offerings as a bad

early experience in which the market might incur severe financial losses for reasons that are avoidable through the exercise of reasonable care. Thus, I would stress that while the market's reaction to the first set of asset sales, even if well-designed, may be conservative, the market's favorable impression of those initial offerings will lead to heightened confidence and increased demand for subsequent offerings.

1. Underwriting Standards:

An investor in any loan sale will be very interested in the federal agencies' underwriting standards used in the creation of the portfolio's loans. The more confident the market can become in its understanding of the nature of the relevant underlying credit guidelines --- and that those guidelines were applied in a consistent and readily understandable manner --- the more precisely the market can evaluate the offering and its attendant risk. Where a government agency's credit extension criteria and/or practices are different from those used in the private sector, the market will attribute higher risk to the loan assets resulting in either a demand for risk adjustment in the type and level of credit enhancement or simple disinterest in the offering.

Since it appears that the government intends not to give "agency status" to the asset-backed securities or provide other recourse to investors in those instruments sold under the pilot program, those individuals responsible for structuring an asset

sale face a substantial task in the very short period of time remaining in FY 87 in educating the potential investors, the rating agencies, and potential credit enhancers to the various agencies' credit criteria and conveying confidence that those criteria were reasonably followed in creating the loans that are to be sold.

2. Credit Enhancement:

As will be discussed more fully below, the Federal Credit Working Group's Guidelines require that the pilot program asset sales be conducted on a "non-recourse" basis.2/ The "non-recourse" policy appears to rule out using an express or implied guarantee of the "full faith and credit" of the federal government, thus shifting the relevant inquiry to which private sector credit enhancement techniques can be used to make the pilot program sales a success. Without the "full faith and credit" of the federal government one of two things will occur: either the net sales proceeds to the government shall be reduced or there will be no asset sales at all.

Beyond the government's own pledge of "full faith and credit" there are many techniques for providing the credit

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2/ For the purposes of these Guidelines, recourse includes any federal guarantees of principal and interest payments, repurchase contracts, agreements to replace bad loans with good loans, warranties relating to collateral value, or any other agreements requiring continued Federal involvement or contingent liability. Any credit enhancement measures, such as reserve funds, over-collateralization, or insurance, shall be the responsibility of the purchaser.

enhancement private investors may need to stimulate market interest in government asset-backed instruments. The market is familiar with the use of letters of credit, bond and personal mortgage insurance, reserve funds, over-collateralization, and senior/subordinated structures to enhance the security of non-governmental asset-backed investments. Such credit enhancement techniques certainly may be used to sell government-related loan assets. However, such private-sector credit enhancements would entail a cost affecting the amount of dollars realized by the government.

3. Documentation:

To the extent that the quality of documentation associated with various agency loans is uncertain to the private markets, investor confidence and interest in the asset-sale can be adversely affected. The lack of standardization of the loans in a portfolio can also lead to problems in pooling loans which are sufficiently similar to allow their use in an asset-backed security. Standardization of the loans and improving documentation can greatly facilitate the pooling of the loans as well as the market's understanding of and comfort with the characteristics of the pooled assets.

One means for overcoming the perceived risk arising from documentation quality is for the agencies to provide warranties as to the documentation in a portfolio. If the agency were to warrant the quality of the documentation and agree to sub-

stitute a conforming loan for any found to be sub-standard, it would greatly reduce the market's concerns with documentation and facilitate the movement of the loan sales to the market. Giving such warranties, however, appears to conflict with the broad "non-recourse" Guideline which the Federal Credit Working Group has established for the government's loan sales. Nonetheless, as I discuss more fully below, such warranties are an example of the type of continued government involvement which may make great sense as a means of maximizing attainment of other objectives of the pilot program.

B. Reaction to Federal Credit Working Group Guidelines.

In our view, two of the Federal Credit Working Group's ten Guidelines for implementing the government's pilot program for loan asset sales have real potential for influencing the market's perception of the desirability of the loan sales.3/ The Guidelines' requirement of non-recourse to the federal government and the transfer of servicing to the private sector can have material impact on the marketability of the loans as well as on the government's realization of the maximum economic benefit from selling those loans.

1. Non-recourse:

A non-recourse policy will increase perceived market risk and therefore increase the compensating return demanded by the

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3/ See Appendix A for a copy of the Federal Credit Working Group's Guidelines.

market for accepting the risk. In the absence of significant over-collateralization or other type of substantial (and expensive) private credit enhancement, the mere "novelty" of the pilot programs --- in effect the market's inexperience with these government loan sales on a non-recourse basis--- suggests that the initial sales may well be greeted conservatively by the market, thereby diminishing the prospects for achieving the goal of maximizing net sales revenues to the government.

Moreover, many of the agency portfolios have substantial borrowers rights provisions that are accorded by relevant statute, regulation or loan transaction documents. The borrowers rights are certainly understandable within the context of the public policy "missions" the agencies are directed to pursue by Congress. However, those public policy objectives do not necessarily comport with the private market's conception of commercial efficiency and economic value. A profit-motivated private investor understandably is uninterested in becoming involved in an investment that entails the potential costs and payment interruptions engendered by such things as borrower counseling and assistance, forbearance, payment moratoria, or administrative appeals. If the "non-recourse" Guideline indeed means that the underwriter and/or private investors must assume responsibility for the government agencies' borrower rights obligations and the that the govern-

ment will not retain any responsibility to the borrowers for those functions (such as by freely substituting another loan for any which becomes involved in a borrowers rights situation), then it is quite predictable that the market will discount the offering to reflect the burden and risk of those obligations.

While apparently conflicting with one another, the "non-recourse" policy and the need to preserve borrowers rights may be accommodated without significant adverse impact on either the Administration's credit reform objectives or the programmatic purposes of the borrowers rights by selectively continuing the government's involvement where necessary. The scope and type of continuing government involvement would depend upon the special requisites of each particular portfolio; what may be necessary in one loan sale may not be in another. For example, the agency might agree to retain the obligation to conduct any administrative appeal procedures before foreclosure or other adverse action is taken. With this type of flexibility, the agencies can judiciously tailor any continuing involvement and restrict their obligations to the absolute minimum amount necessary to assuage the market's inexperience with owning government loans on a non-recourse basis. In so doing, the agency can reduce the need for more costly private sector credit enhancement and increase the market's interest in and valuation of the offering, while maintaining the integrity of

the borrowers rights or other public policy aspects of the agency's "mission".

I would hasten to add that a continuing government involvement would not necessarily gut the subsidy valuation which the Federal Credit Working Group seeks to derive from the asset sales. By comparison of the results achieved from various loan sales which involve different types of its continuing involvement, the government may still be able to construct a meaningful estimate of the subsidies inherent in federal credit programs. The use of a more flexible approach with respect to continuing government involvement may produce over time higher net sales revenues for the government as well as a higher level of attainment of the various goals of both the credit reform initiative and the asset sale pilot program than might be the case with a strict policy which prohibits any continuing involvement by an agency subsequent to the sale of its loans.

2. Servicing:

The Guideline requiring transfer of the servicing of the loan portfolio entails certain advantages, but it also creates potential problems somewhat related to the recourse/non-recourse issue. On the positive side, private sector servicers have a much stronger financial incentive than do the federal agencies to conduct commercially efficient, state-of-the-art operations designed to keep accounts current and accurate.

The transfer of servicing has negative implications as well though. For example, is a private sector servicer expected to conduct the oftentimes substantial and possibly lengthy administrative appeal procedure now made available to borrowers when adverse action (e.g. foreclosure, graduation, or reduction/elimination of interest subsidy) might otherwise appropriately be taken by the agency if it had retained the loan and the servicing function? We are well aware of the concern in Congress that a private sector servicer may lack the level of empathy for the borrower traditionally demonstrated by the agency, or that because of commercial necessity the private servicer may simply feel unable to work with the borrower to the extent the agency may be willing to do.

C. Credit reform initiative.

The public policy implications of the Administration's credit reform initiatives are several and far-reaching and are being addressed at length by the OMB, GAO and agency witnesses at these hearings. Rather than addressing the policy arguments per se, I want to focus on the expanded pilot loan sales contained in the Administration's FY-88 budget and the impact the credit reform initiative may have on the private capital market's overall evaluation of the pilot program asset-sales.

First, the goals of the Administration's credit reform initiative are innovative and ambitious and could have far reaching positive economic effects on the manner in which

government extends credit to the public. While the limited number of pilot program sales that may be capable of moving to the market in the balance of FY-87 will probably not provide an ultimate basis from which to draw conclusions as to the major policy questions regarding loan asset sales, I regard them as an important first step in exploring and developing a much needed system for credit reform. Experimentation with a number of different asset sale approaches is envisioned in order to explore federal credit reform from many perspectives. Something new can be learned at each step from the analysis and review of each loan portfolio. The variety of government loan portfolios almost demands this kind of experimentation. Because of these factors, I regard the expanded pilot program called for in the Administration's FY-88 budget as the desirable and most effective way of developing the data needed to explore the public policy alternatives of federal credit reform and to develop the necessary interest and acceptance of government asset sales in the private capital markets. From our perspective on Wall Street, a controlled, deliberate, yet expanding pilot program of asset sales over the next 18 months will facilitate market acceptance of the sales and maximize the net revenues derived therefrom for the government.

Second, as a result of the credit reform initiative the agencies have made substantial strides towards determining the quality of the documentation relating to their loan portfolios.

The credit initiative has begun to reveal those situations in which documentation is deficient. As the government now originates new loans with an eye toward future loan sales, the quality of documentation likely will continue to improve.

Third, as noted previously, the transferral of the servicing function to the private sector should improve servicing performance as well. In contrast to the federal agencies, private sector servicers have a much stronger financial incentive to conduct their operations with state-of-the art efficiency.

Fourth, in order to maximize the liquidity of the loan-asset securities it is beneficial that the government commit to selling a sufficient volume of assets. In doing so on a sustained basis, with newly originated as well as currently outstanding loans, a vibrant secondary market can be created. If the volume is low or it is perceived that the government may cut short its commitment to future sales of similar loan portfolios, it will reduce the liquidity of the asset-backed instruments involved in the pilot programs.

Fifth, while the debate over "on" or "off" budget credit accounting has been conducted to date as if the budget scoring must be wholly one or the other, I have noticed the GAO's recent suggestion that some form of mixture of the two concepts might actually be the better, more accurate accounting system and preserve some budgetary incentive for the Administration to

continue to pursue asset sales. In particular, GAO has suggested that the portion of asset sale proceeds that represents the estimated amount the government would have to pay under a recourse provision should be treated as borrowings for budget purposes, and the balance of the sale proceeds should be treated as receipts. Perhaps such a mixed accounting system may enable the Administration to achieve its credit reform objectives more fully while significantly enhancing the net sale proceeds attainable through the asset sale program.

D. Implications for the SBA loan-asset pilot program sales.

The points raised in the preceding sections of my testimony apply to the SBA pilot programs. As part of its supervised credit programs, the SBA loans incorporate subsidized interest rates, borrower counseling, forbearance policies and similar public policy features which the market has not had to evaluate in dealing with non-governmental asset-backed securities. Consequently, the market's concerns with SBA's underwriting standards, loan documentation, and credit enhancement will pertain to the sale of the SBA portfolios. These are not insuperable obstacles, but will require careful study in order to structure the SBA loan sales for success. I believe that if structured and timed properly, the sale of SBA loans can be successful and have no material adverse impact on other SBA programs or existing secondary markets.

I urge the Committee to take a longer view of the pilot

program, acknowledging that it is an experiment without direct precedent, but appreciating that important keys to making the asset sales a success are their timing and the agency's education of the private capital markets. The Committee should expect that in the initial SBA offering the spread over Treasury issues may be larger than in subsequent offerings. The reason: the market must be given time to acquaint itself with the SBA programs and the loans generated therefrom. As the markets get more comfortable and confident with SBA loan assets, the spread to Treasury issues should stabilize within a tighter range. One recent example of this phenomenon arises from the first offering of SBA guaranteed certificates of participation in a pool of SBIC debentures on September 17, 1986, which initially sold at 125 basis points over the Treasury yield curve. Only four months later, on January 28, 1987, the second such offering sold at 80 basis points over the Treasury yield curve.

I believe that the analysis and sale of direct loans of the SBA and other agencies of the Federal Government is an important and effective step in bringing about credit reform. I have every reason to believe that if the asset sales are well-structured and well-timed, the private capital markets will be very receptive to the pilot program. The discussion generated by this Committee among the SBA, GAO, OMB, and the capital markets demonstrates that flexible and effective

measures are being considered to meet these challenges. We are ready to join in the kind of public and private sector partnership which will be necessary to bring about the effective and responsible sale of SBA loans and the accomplishment of credit reform in the federal budget.

In conclusion, Mr. Chairman, First Boston believes that:

- The asset sales can be conducted successfully under the Federal Credit Working Group Guidelines, if those Guidelines are flexibly administered.

- The potential conflict between the "non-recourse" policy and the need to preserve borrowers rights should be accommodated during a transition period by selectively continuing the government's involvement in a portfolio where necessary. This might reduce the need for more costly private sector credit enhancement and increase the market's interest in the loan sales, while maintaining the integrity of the borrowers rights and other public policy goals of the agencies.

- As the transition period proceeds, the market acceptance of well-structured asset sales will improve and the spread over the Treasury yield curve might narrow.

Let me thank you for inviting First Boston to share our views with the Committee. First Boston is available to help you in the future and I would welcome any questions you may have.

Appendix A

July 8, 1986

GUIDELINES FOR LOAN ASSET SALES

I. Introduction

The following guidelines for the sale of loan assets have been established and approved by the Federal Credit Working Group. The guidelines are designed to insure that agencies will meet the objectives of the loan asset sale pilot program which have been derived from the Administration's stated priority to reform Federal credit. These objectives are set forth as follows:

- o reduce the Government's cost of administering credit by transferring servicing, collection, and other administrative activities to the private sector;
- o provide an incentive for agencies to improve loan origination and documentation;
- o determine the actual subsidy of a Federal credit program; and
- o increase unified budget offsetting collections in the year of sale.

II. Guidelines

The following guidelines shall be adhered to by each agency in its approach to, and implementation of, all loan asset sales.

A. Loan asset sales shall be made without future recourse to the Federal Government. For the purposes of these guidelines, recourse includes any Federal guarantees of principal and interest payments, repurchase contracts, agreements to replace bad loans with good loans, warranties relating to collateral value, or any other agreements requiring continued Federal involvement or contingent liability. Any credit enhancement measures, such as reserve funds, over collateralization, or insurance, shall be the responsibility of the purchaser.

B. Loans of tax-exempt entities shall be sold only if the future interest payments on the loans are subject to full Federal income tax. This does not preclude sale to tax-exempt investors. Exceptions may be made in cases involving sale of loans on a whole loan basis.

C. Collection and servicing shall be transferred to the purchaser with sale of a loan asset.

D. Pilot program loan asset sales shall begin in FY 1987 after final approval of plans for sale.

E. Under the pilot program, agencies shall sell loans whose face value in the aggregate is equivalent to the amount stated in the FY 1987 budget. Agencies shall sell some newly issued loans and may sell seasoned loans from their portfolios.

F. Where appropriate, each agency shall choose, through a competitive process, a professional financial consultant to provide expertise on its loan asset sale program. Consultants will not be permitted to purchase loans from programs on which they are advising.

G. Loan asset sales may be conducted on a competitive bid or negotiated basis. In the latter case, the invitation to negotiate should be disseminated widely, and negotiations conducted as competitively as possible.

H. In limited circumstances where the borrower is not an individual, agencies may offer current borrowers the right to purchase their loans if that seems likely to achieve the highest price; borrowers who are not current on their principal and interest payments shall not be allowed to purchase their loans.

I. Loan asset sales shall be sufficiently large to assure market interest. This is particularly important when developing markets for new types of securitized loans. In such cases, we would expect sales to be over $100 million. Other details, including timing of sales, the composition and size of loan pools, and other marketing issues, shall be handled individually by each agency and will vary from portfolio to portfolio depending on market conditions.

J. Agencies may sell loan assets held by the FFB.

Chairman LAFALCE. Our next witness will be Mr. Clare.

TESTIMONY OF MICHAEL K. CLARE, VICE PRESIDENT, CITIBANK

Mr. CLARE. Good morning. My name is Michael Clare. I am a vice president of Citibank. I am in charge of Citicorp Investment Bank's Government finance activities.

Mr. Chairman, I want to thank you for the opportunity to appear here before your distinguished committee today and to share my views with you regarding the proposed Federal Loan Asset Sales Program.

Your invitation requested that the comments made today cover a variety of topics. Included was a request for a reaction to the September 1986 GAO report entitled "Loan Asset Sales."

The primary objective of the report was to opine upon whether or not OMB's loan asset sale guidelines will result in realizing the maximum net proceeds practicable and whether these guidelines will permit the Government to effectively use available services of the secondary credit markets.

In light of the primary objective of the GAO's report and my experience in the credit markets, my comments today will focus specifically on the recourse/nonrecourse issue, the appropriateness of transfering servicing to the ultimate purchasers, and how the agencies may begin to prepare documentation and information for an ongoing sales program.

With respect to the recourse/nonrecourse issue, we believe that OMB's guidelines have placed onerous constraints on both maximizing the Government's net proceeds and efficiently utilizing the credit markets when applied to most—if not all—loans proposed for sale in the pilot program. In our opinion, the GAO has correctly concluded that loans offered for sale on a without-recourse-basis will not produce the same net proceeds to the Government, as if the same assets were sold in the private markets with full or partial recourse.

It is also worth mentioning that current law would preclude commercial banks, such as Citibank, from purchasing and reselling most nonrecourse loans. As a result, the competition to purchase the nonrecourse portion of such assets would be restricted to the investment banking community.

Chairman LAFALCE. That means that you could not participate, does it not? Except as an advisor?

Mr. CLARE. That is right. As an advisor.

Chairman LAFALCE. Or as a placer.

Mr. CLARE. As a placement agent, that is right. The nonrecourse guideline is, however, a logical constraint, given the budgetary treatment OMB would afford asset sales. As the GAO report mentions, if assets were sold with recourse they would be scored as borrowings, although this is inconsistent with the normal budgetary treatment of Government guaranteed obligations.

Examples of loans being sold with recourse and which are not scored as borrowings include moneys raised to fund the certified development companies and the SBIC industry. As you are aware, these are two SBA-sponsored programs.

We appreciate that the debate on the recourse/nonrecourse issue is continuing. Our message is, however, that assets, by and large, can be sold on either basis, but the Government will certainly realize greater net proceeds if the sales are made on a recourse rather than nonrecourse basis.

The second issue on which I would like to comment has to do with the OMB guideline requiring that responsibility for collection and servicing be transferred to the purchaser with the sale of a loan asset. We concur with the GAO's view that linking the purchasers with the servicing function should be avoided. We believe further, that it is highly counterproductive and could materially and adversely impact the net proceeds to the Government if this guideline is mandated.

Many important U.S. institutional investors neither have the capability or the interest to undertake the servicing, and if faced with this requirement, would simply opt not to buy. This requirement could also create chaos if a secondary market were ever to develop in loan assets and the servicing followed.

It is also worth mentioning that certain portfolios, which we have reviewed, might logically be of great interest to non-U.S. buyers. Imagine the inefficiencies that could result in locating servicing outside the United States.

Chairman LAFALCE. Wait a minute. Who is going to want to buy this stuff if they are going to have to service it also?

Mr. CLARE. There could be some entities that would do it, but not many.

Chairman LAFALCE. That is really going to reduce your price tremendously, is it not?

Mr. CLARE. More importantly, the logical buyers are not efficient servicers.

Mr. COOPER. Who would they be? Who are the logical buyers?

Mr. CLARE. Logical buyers? Probably pension funds, insurance companies.

Chairman LAFALCE. They are just not in the business of servicing these things. Go ahead.

Mr. CLARE. We believe it would be much more efficient, productive, and cost effective to permit the agencies to separately contract for collection and servicing. The purchasers, however, should jointly pay for these services and retain the right to make changes if required or appropriate.

To illustrate the scope of the servicing task for SBA, we have been told that the business loan files are located in, and serviced through, 115 SBA district offices located in all 50 States. Transferring the services with respect to these loans will entail the physical review of all loan files to be sold, a cataloguing of all the documentation, completion of any incomplete files, and conversion of SBA files to the servicers' computerized systems. An undertaking of this magnitude should be reserved for those specializing in such tasks.

Going forward, and assuming that sales proceed on a regularly scheduled nonrecourse basis, what are some of the things the agencies might want to consider to enhance the marketability of their assets? For starters, it would be most helpful if the documentation evidencing the underlying loans was standardized and carefully reviewed by the financial community so as to make it as commercial-

ly acceptable as possible. Next, it would be extremely helpful if the documentation were then centralized and readily available for review.

The agencies may also find it beneficial to minimize the financing options made available to users. This would greatly facilitate the pooling of loans with similar terms and conditions. The objective here is to offer packages to the investing public which are as homogenous as possible. You might then wish to consider offering these packages to investors on a regular and predictable basis.

Finally, it would be recommended that management information systems be developed which enable accurate and timely data to be disseminated to potential investors. This information might target to establish predictable valuations of the cash-flows of a given pool of loans. It would highlight actual experiences with respect to the timeliness of payment, the timing and amount of defaults and the timing and amount of recoveries on defaulted loans. Managing the flow of financial information in this way would enhance the value of the offerings by giving comfort to investors as to the predictability of the cash-flows. An efficiently working model of how regularly scheduled loan sales could work going forward exists today in the enormous mortgage market. Over time, this market has developed and standardized the flow of information to the point where investors feel they can predict within an acceptable range of error, the cash-flows they will receive when purchasing enormous pools of residential mortgages.

The techniques have been mastered and are working. You just need to take advantage of what has been learned and make it available to our friends in Washington.

Thank you very much, Mr. Chairman. If you have any questions, I will be pleased to respond.

Chairman LAFALCE. Thank you very much, Mr. Clare.

Now we will hear from Mr. Moffitt. But before we hear from Mr. Moffitt, the thought enters my mind. I would appreciate it if the four of you gentlemen would submit a letter to me with great specificity indicating your recommended changes in the OMB guidelines. Know in advance, I am not very receptive at all to the concept of letting a financial advisor also be an underwriter because I think you would have irreconcilable conflicts. You would be serving two separate masters. You have to have one master as advisor to the Government. As soon as you become an underwriter you are serving yourself.

[Mr. Cooke's response follows:]

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Committee on Small Business

First Boston

April 3, 1987

The Honorable John J. LaFalce
Chairman
House Small Business Committee
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman LaFalce:

On March 12, 1987, I testified at your invitation before the Small Business Committee on behalf of The First Boston Corporation regarding the federal credit reform initiative and the loan asset sale pilot program. At that hearing you requested each of the panelists to provide a letter detailing possible modifications in the Federal Credit Working Group's Guidelines for implementing the loan asset sales which might improve that pilot program. This letter responds to your request.

First Boston believes that the asset sale pilot program can be conducted successfully within the Guidelines. We do not recommend that those Guidelines be changed substantially as much as we suggest that the agencies adopt a flexible application of Guidelines during the next 18 months in order to facilitate the transition of the loan portfolios from government to private ownership. As I emphasized in my testimony, without the "full faith and credit" of the federal government backing the loan sales one of two things will occur: either the net sales proceeds to the government shall be reduced or there will be no asset sales at all. First Boston believes that a strict application of the Guidelines' "non-recourse" requirement will increase perceived market risk and therefore increase the compensating return demanded by the market for accepting the risk. For example, if the "non-recourse" Guideline means that the underwriter and/or private investors must assume complete responsibility for the government agencies' borrowers' rights obligations, it is predictable that the market will discount the offering to reflect the burden and risk of those obligations.

To remedy what may be the adverse impact of a strict "non-recourse" policy, we suggest that the federal agencies consider

maintaining some selective continuing involvement in the various portfolios where necessary. The selective continuation of the government's involvement in the portfolios can accomplish the essential purpose of the "non-recourse" policy (i.e. quantification of the subsidy value) while accommodating the borrowers' rights concerns. The scope and type of continuing government involvement (assuming any is needed at all) would depend upon the special requisites of each portfolio.

The Guideline requiring transfer of the servicing of the loan portfolio to the private section also would benefit from a flexible application during the transition period. For example, it may not be necessary or advisable to transfer all the servicing for a portfolio at once; rather, the servicing might be gradually transferred to the private sector over time to avoid disruptions and to facilitate a smoother transition. Such a gradual transition may bolster private investor confidence in the portfolio.

First Boston does not agree with the suggestion made by one of the other panelists at the hearing that the Guidelines ought to be changed to permit a single firm to serve both as an agency's financial advisor and as the underwriter for the same portfolio. Such a situation raises too great a potential for conflict of interest and could negatively affect the maximization of loan sale net revenues. This is not to say that a single firm should be prevented from serving as an agency's financial advisor on one portfolio and as underwriter on a wholly separate portfolio. This is a completely different situation which does not present conflict of interest or revenue maximization issues.

First Boston appreciates the opportunity to provide its views to the Committee. Should you have further questions please feel free to contact me at your earliest convenience.

Sincerely,

Hal Cooke

Harold E. Cooke

HEC/jmb

Chairman LAFALCE. Mr. Moffitt.

TESTIMONY OF JOHN MOFFITT, ACTING ASSOCIATE DEPUTY ADMINISTRATOR FOR MANAGEMENT AND ADMINISTRATION, SMALL BUSINESS ADMINISTRATION

Mr. MOFFITT. Thank you Mr. Chairman. It is a pleasure to appear before you today. Thank you very much for the invitation.

I am John Moffitt, the Acting Associate Deputy Administrator for management and administration of the Small Business Administration. I have a full written statement and response for questions you had in your invitation letter that I would like to have inserted in the record. I will just make a very brief statement now, if I may.

The current SBA budget proposal calls for the sale of assets producing receipts of $277 million in fiscal year 1987 and $643 million in fiscal year 1988. These receipts would be derived from the sale of $800 million in disaster home loans in fiscal year 1987, and $2.2 billion in business loans, disaster business loans, and 503 loans owned by the Federal Financing Bank in fiscal year 1988.

Thus far, we have taken two steps to accomplish this sale. First, we have issued an RFP for an independent financial advisor whose expertise would assist us in the planning of all phases of the proposed sale. We have received 13 submissions as a result of the RFP. They are currently being evaluated. We hope to make a final selection within the next 2 or 3 weeks.

Second, we have submitted to OMB a plan for the sale of current disaster home loans back to the individual disaster borrower. A decision on this proposal is pending.

This agency has and will continue to proceed in an orderly and responsible manner, mindful of our obligations to protect the legal rights of our borrowers as well as the legitimate interests of the taxpayers. We are anxious to avoid not only the perception but also the reality of a fire sale of Government assets.

We will be pleased to keep this committee fully informed of our progress and findings as we go along. And, of course, we extend this pledge of cooperation to the Senate committee counterpart.

I know that our incoming administrator shares this desire to work together in a spirit of amicability. We realize that in dealing with asset sales we are navigating in uncharted waters. I would welcome, Mr. Chairman, any comments or insights which you or members of your committee may provide.

Once again, we thank you for this opportunity to appear.

Chairman LAFALCE. Thank you very much for your brief statement, Mr. Moffitt.

[Mr. Moffitt's prepared statement, with attachments, follows:]

PREPARED STATEMENT OF JOHN MOFFITT, ACTING ASSOCIATE DEPUTY ADMINISTRATOR FOR MANAGEMENT AND ADMINISTRATION, SMALL BUSINESS ADMINISTRATION

Mr. Chairman, let me thank you for the invitation to appear before the Committee this morning. I would also like to congratulate you as the new Chairman of this distinguished Committee. I am accompanied here today by Edwin T. Holloway, Associate Administrator for Finance and Investment and Lawrence R. Rosenbaum, Acting Comptroller.

SBA Policy on Asset Sales

In its last three budget submissions, the Administration has proposed the sale of portions of SBA's loan asset inventory. As I believe Mr. Wright explained to you earlier, the objectives of the loan asset sale initiative are to--

- reduce the Government's cost of administering credit by transferring servicing, collection and other administrative activities to the private sector;

- provide an incentive for agencies to improve loan origination and documentation;

- determine the actual subsidy of a Federal credit program; and

- increase unified budget offsetting collections in the year of sale.

In its 1986 budget submission, the Administration proposed to sell SBA loan assets with a face value of $12.1 billion over a four year period, from 1986 to 1989. As a result of the finally enacted 1986 budget, no sales were actually made.

Last year we proposed the sale of $13.1 billion in assets over a five year period, beginning in 1987. Congressional action on this issue was not completed, as the SBA portion of the Reconciliation legislation died in conference.

This brings us to the Administration's current budget proposal. In our 1988 budget we are proposing a two year program. In 1987 we plan to sell $800 million in Disaster Home Loans. In 1988 we would sell $740 million in Disaster Business Loans, $1 billion in 7(a) Business Loans and $500 million in 503 loans owned by the Federal Financing Bank, for a 1988 total of $2.24 billion.

The FY 1988 budget request provides for $277 million in asset sales receipts to offset FY 1987 outlays and $643 million in asset sales receipts to offset 1988 outlays. The actual amount, or face value, of the portfolio to be sold will depend on the ultimate rate of return on the sales. In other words, we plan to sell assets sufficient to meet our target for receipts in 1987 and 1988.

Direct Loan Portfolio Description

These assets will come from a total direct loan portfolio consisting of some 248,000 loans with an outstanding balance of approximately $9.3 billion. It consists of —

- 42,000 loans in the Business Loan and Investment Fund with a balance of $2.9 billion. These are loans from the categories of Regular Business, Economic Opportunity, Handicapped Assistance, Energy, Veterans, 501 and 502 Development Company, and 7(a) and 503 guaranteed loans that have been purchased.

- There are some 4,000 503 Development Company debentures with a balance of $900 million that are in the Federal Financing Bank portfolio.

- Then we have 200,000 Disaster loans for $4.0 billion. These include home loans, business loans and farm loans.

- Finally, we have approximately 2,000 SBIC and MESBIC debentures with a face value of approximately $1.5 billion.

We are not presently preparing to sell SBIC debentures or MESBIC debentures and preferred stock. Guaranteed loans owned by private sector participants, which make up the remainder of our portfolio, cannot be sold.

Current Preparations for Asset Sales

We are currently in the initial planning phase at SBA for implementing the asset sale program. Our first major task has been to set in motion the steps necessary to hire an independent financial advisor to assist the SBA in all aspects of developing a marketing plan for the sale to investment markets of the loans described above. SBA is currently reviewing bids that were submitted in response to a Request for Proposals that was issued on January 23 of this year. We expect to complete the process of choosing the financial advisor within the next two weeks.

The Advisor's first task will be to assist SBA in the development of a comprehensive management plan for the asset sales. The plan will discuss the marketing, cost and net revenue effects of the sale of assets without recourse to SBA and with partial or full recourse to SBA. After review and any necessary modifications, SBA will consider the plan to serve as the overall strategy for the sales.

Next, the Advisor will assist SBA in structuring the loans in the portfolio into marketable units that can be readily sold to private investors. Loans could be packaged in various ways. They could, for example, be grouped or pooled in relatively homogenous units with common characteristics such as interest rates and maturity. Or they might be grouped without regard to such characteristics. A pool might be established in which undivided interests in such a pool might be marketed. Or the pool could be used as collateral for a separate securities offering.

Finally the Advisor will develop marketing strategies to carry out the sales of the structured loan packages. Marketing options might include, among other possibilities:

- Selling the loan packages to a single financial institution that will act as an intermediary for collection and servicing the loans on behalf of the investors;

- Selling several packages to one or more financial intermediaries for resale to investors;

- Sale on a local or regional basis to intermediary financial institutions which purchase for their own account; or

- Direct sale to investors.

The investment advisor will analyze the advantages and disadvantages, anticipated proceeds and expected prices and discounts and make recommendations on the timing of the sales. SBA will then consider the recommendations in the final report.

The Advisor may also assist in the development of a plan to offer Disaster Home Loan borrowers the opportunity to prepay their loans at a discount. Such a proposal is currently under consideration within the Administration, with a final decision being deferred until the Agency's new Administrator can address the matter.

Mr. Chairman, in your letter of invitation you asked us to address a number of other issues, and SBA's response is included as an appendix to this statement.

This concludes my prepared remarks Mr. Chairman. I would be pleased to respond to any questions that you or the Committee might have.

WITNESS STATEMENT FOR HOUSE SMALL BUSINESS COMMITTEE
HEARING ON LOAN ASSET SALES

APPENDIX

RESPONSES TO QUESTIONS IN CHAIRMAN'S LETTER

Q. The Committee solicits your reaction to the September 1986 GAO Report entitled "Loan Asset Sales" (GAO/AMFD-86-79).

A. The following is a summary of the points made in the GAO report regarding the OMB guidelines for the sale of loan assets and SBA's comments thereon.

I. The major conclusion was ". . . that OMB's guidance to agencies in these two areas will result in not protecting the government's best interests because the government will not be maximizing the net proceeds on the sale of certain loan portfolios."

- o GAO does not factor into the calculation of net proceeds to the government the following items:

    1. the reduction in collection costs for these loans,

    2. the reduction in administrative costs for maintaining records for these loans,

    3. the reduction in the continuing credit evaluation expenses, and

    4. the increase in the government's contingent liability resulting from sales with recourse to the government.

II. GAO states ". . . We believe that this objective also includes an implicit responsibility to protect the government's interests by selling loan assets on a basis that produces maximum net proceeds practical at minimum risk."

- o By selling the loans any other way than without recourse the government is not selling at minimum risk.

- o Even collateralized loan sales which appear to eliminate the government's risk do not have that effect. As a practical matter, if investor expectations regarding performance of the portfolio are not met, complaints would be directed to the Congress and the agencies, causing additional work for both entities.

III. The GAO report states ". . . Concerning loan asset sales, OMB presently proposes to determine the subsidies by measuring the difference between the face value of the loans offered for sale and the amount for which the loans are purchased. OMB's proposal is inconsistent with Circular A-70 and, in our opinion, does not measure loan program subsidies."

- o There is an economic subsidy to SBA borrowers because they receive loans at rates that are below the rate such a business would normally pay. The amount of this subsidy flucutates with market interest rates. For example, SBA has some 7(a) direct business loans with interest rates approaching 15%. There is very little economic subsidy to the borrower on these loans today; however, there was a larger economic subsidy when the loan was made. The amount of subsidy at the time of the sale of the loan would be measured. While the sale of a loan today may not measure the subsidy at the time of loan approval, it does measure the subsidy enjoyed by the borrower at this time.

IV. The GAO report identifies investor unfamiliarity as a problem with the sale on a non-recourse basis.

- o While such loans have not been sold before, there has been a tremendous interest in the proposed sales. Several newspapers and magazines have published articles describing the types of loans for sale. SBA has received requests for a copy of the financial advisor RFP from approximately 90 entities. By the time the sales actually take place, the unfamiliarity of investors with these issues should be overcome.

V. Creditworthiness of borrowers, loan terms and documentation, high default rates, and modifications to initial terms and repayment periods were also listed by GAO as impediments to a successful sale.

- o These items are all fundamental aspects of credit. They will be factored into the bid made by any prospective purchaser. If the government takes any steps to limit the risk caused by these factors, then it would not be selling the loans with a minimum of risk.

- o These factors are considered by any investor for any sale. The fact that certain parameters for government loans are different from those commonly encountered in the private sector will affect the bid, but these do not have to be "enhanced" for the sale to be successful.

Q. The Committee is concerned about the impact of loan asset sales under OMB guidelines on the ongoing operations of federal agencies and their loan programs. The effect of such sales on the legal and contractual rights of borrowers such as small business conerns and homeowners is, of course, of particular concern.

A. At issue here is whether the Small Business Act, regulations issued pursuant to the Act, or servicing SOP's will affect investors who purchase SBA loan assets without recourse. Also at issue is whether borrowers will have any legal remedies against the investors.

The holder's responsibility will depend on the nature of the asset sold. The terms and conditions of the sale and contractual obligations contained in the Note or other loan documents will be binding on any holder or servicing agent unless altered by the terms and conditions of the sale. Additional responsibilities may arise under State or Federal laws controlling credit transactions and collections.

Existing legislation controlling SBA and existing SBA procedures will not affect the holders. For example, an investor need not adopt SBA's reluctance to foreclose on a personal residence.

A borrower will have a cause of action against a holder who violates the note, other loan agreements, or applicable laws. The borrower will not have a cause of action against the holder for failing to follow the requirements of statutes or SOP's which do not apply to the holder.

It should be kept in mind, however, that the terms and conditions of any sale are governed by the tenor of the agreements and the tenor of the documents. Thus, for example, the intent of various points of SBA regulations or SOP provisions could theoretically be reflected in the tenor of these agreements and documents. Such issues would be points of negotiation in the deliberations leading up to the closing on any sale of assets.

Q. The Committee would also like to have SBA's assessment of the reaction of the investment and commercial bankers and the investing public to the administration's proposed sale of SBA loan assets.

A. The SBA's investment advisor will be providing this information to the SBA.

Q. Would SBA recommend going forward with loan asset sales if such sales, without recourse under OMB guidelines, actually result in minimized net proceeds and hinder the secondary market, i.e., without regard to the consequences?

A. The first task of SBA's investment advisor is to assist SBA in the development of a comprehensive management plan for the sales of loan assets contemplated. The plan will discuss the marketing, cost and net revenue effects of the sale of the loan assets without recourse to SBA; and with partial or full recourse to SBA. SBA will review the plan in consultation with the Office of Management and Budget and the Department of Treasury and after any necessary modifications, may adopt the plan to serve as the overall strategy for loan asset sales.

Chairman LAFALCE. I have asked a number of questions. Therefore, I will defer my many additional questions until the conclusion of the other members' question period.

Mr. Ireland.

Mr. IRELAND. Thank you Mr. Chairman. I do not have any questions. I would just like to comment that it is a treat to hear the voice of the market. Too often in our occupation of setting policy, we go off into the yonder without hearing gentlemen as we have heard here today. I think they have made a real contribution. I thank you all very much.

Chairman LAFALCE. Thank you. Mr. Cooper.

Mr. COOPER. Thank you Mr. Chairman.

I was curious with Citicorp's point that they were not able to compete on the basis of which they would like to compete. I was wondering if Citicorp had a different sort of fee schedule or any sort of promise that if you were allowed to compete that you could do it at a cheaper rate, more efficiently, than one of the investment banks.

Mr. CLARE. Unfortunately, it is not a matter of price. It is a Glass-Steagall restriction.

Mr. COOPER. Assuming that restriction were reduced or eliminated, can you do a better job at the same game, or do you just want to get into the same game?

Mr. CLARE. Absolutely.

Mr. COOPER. What evidence do you have of that; that you could do a better job?

Mr. CLARE. We have none with us here today.

Mr. COOPER. In general, what sort of fees are we talking about? Is this the sort of transaction that the investment banks are eager for because they are lucrative or because you desire to do a public service? What is the incentive?

Mr. WARNER. Can I respond to that? The fees which are being discussed in connection with the four mandated high quality loan sale programs will be the standard underwriting commission spreads for the highest rated securities sold in the public markets.

So one is looking at triple A, double A rated debt. The spreads or commissions are standard throughout the industry. Relatively speaking, it is the scale based upon the maturity of debts sold. And on the high end it goes toward three quarters of 1 percent to seven-eighths of 1 percent on the sale of long-term, fixed-rate, high-quality debt.

Mr. COOPER. So that is a commonly accepted percentage in the industry?

Mr. WARNER. That is right. And that divides into three components. One component is management, which is shared among the managers who actually spend, typically, months in the preparation of the various legal offering documents. A second is underwriting. And that pertains to the market risk that the underwriting group takes in purchasing on day 1 and selling on day 2.

And the third and largest component invariably is selling. That compensates the firms who actually sell the debt.

Mr. COOPER. This sort of commission basis, whatever you want to call it, is substandard. Would you then expect much price competition among the various competitors?

Mr. WARNER. No; I think that one is looking at a certain standard which is required to utilize the global marketplace. If a firm were to come in, for example, and say well, we will underwrite for one-eighth of 1 percent, maybe that firm could underwrite at one-eighth of 1 percent. But it would be that firm alone. And that would obviously negate many of the advantages you will see here in terms of pricing.

Mr. COOPER. How then can the Government pick and choose among competing underwriters if price is not a basis?

Mr. WARNER. Each of the programs which are being sold will require different structuring and different solutions. Because of the fact that the environment requires nonrecourse sales, a great deal of ingenuity and expertise is required. In addition, there are obviously some firms which have experience in dealing with enormous issues and some which do not. It is quite different to sell a million dollar issue than a billion dollar issue.

It will be clear from the competitive process that the agencies are all going through, that some banks are going to have far more detailed, thoughtful, and program-responsive proposals, and far greater marketing and distribution skills than others. So while the commissions will look reasonably similar, although there may be some slight differences, the responses will be competitive and greatly varied.

Mr. COOPER. Is there any problem for an investment bank that serves in an advisory role from one type of SBA issue and underwrites another type of SBA issue? Does that create the possibility for conflicts of interest even though they are separate technically but still within the same Government agency?

Mr. WARNER. That is a very interesting question. Just thinking back on my knowledge of the FAR regulations and also with respect to OMB guidelines section 2F, I think our view would be that different portfolios are viewed, even in the same agencies, as separate and distinct for purposes of FAR and the OMB guidelines.

Mr. COOPER. Do you think for safety reasons we need to, perhaps, have a guideline that is more limiting than that on the investment bank so that if you serve in an advisory capacity for an agency that you would not be allowed to underwrite for any other issues from that agency?

Mr. WARNER. No; I do not think that we would favor that because I think that the programs are really quite fundamentally different. And if I can cite one concrete example right now, sir. Farmers Home Administration has two portfolios mandated by Congress for sales. One is a community development loan portfolio; and the other is the single family rural housing section 502 portfolio. These are very, very different portfolios.

And the fact that one bank were to act as financial advisor in one portfolio would in no way substantively give them any kind of benefit in terms of trying to successfully compete for the structuring of a radically different portfolio.

Mr. COOPER. One last question. I assume when you sell market debt for companies held in low prestige, that hurts the offering. It hurts the price. Periodically, we in this country have lower prestige than perhaps we should. I was wondering, is it possible for the

market to place a discount on lack of prestige for a particular Government agency at a particular time?

Mr. WARNER. What is being sold here are not Government agencies or the prestige or lack of prestige of a Government agency.

Mr. COOPER. But we are relying on the quality of the bureaucrats writing the loans and having made the credit judgments. And if they are experts, why then you have a good loan. If they are not——

Mr. WARNER. Actually, I think what is going to be relied upon here by investors is going to be among other things, the work which is done by the underwriters, the work which is done by the agencies in successfully bringing the documentation together for a sale, and as I mentioned in my testimony, the key element of having an independent credit rating. So that once it has been structured and once that rating goes on, it is no longer a loan so much from *x* agency to *y* agency. These are loans which are packaged, securitized, and have received double A or triple A rating from the rating agency.

Mr. COOPER. To me it seems if that were true, you would not care if they were recourse loans anymore. You would not care whether the Federal Government stood behind them. You would be willing to rely on this process you are setting up for rating.

Mr. WARNER. Oh, absolutely. As you may recollect, it is our view that tens of billions of dollars of loans in the U.S. Government portfolios can be sold completely without recourse. Equally, that these tens of billions of dollars of loans can be serviced aggressively and willingly by third party servicers.

Mr. COOPER. I am afraid my time has expired Mr. Chairman.

Chairman LAFALCE. Mr. Hiler.

Mr. HILER. Mr. Chairman, I wonder if I might defer to my two colleagues who were here somewhat before me.

Chairman LAFALCE. Absolutely. Mr. Hefley.

Mr. HEFLEY. No questions Mr. Chairman.

Chairman LAFALCE. Mr. McMillan.

Mr. MCMILLAN. First I want to thank each of you for coming this morning. I think you have given us very enlightening testimony.

The notion has been expressed, having to do with the potential markets for these securities. Is it likely, assuming that we proceed down the road and we make all the right decisions and create a consistent flow of well-documented, appropriately designed securities, that a special regulated investment company market might develop for this type of security that would specialize in the holding of these Government securities? Would that be in the picture as you see it? Or would you see the market existing among existing institutional and perhaps, some individual investors?

Mr. BLUME. I would suggest that you will not see the creation of a new type of investor. Various kinds of existing investors will buy this paper depending on how it is structured. You will have the same investors buying it that buy similar kinds of paper.

Mr. MCMILLAN. The reason I raise that, is that several of you have mentioned the problem of passing on the servicing aspect. It seems to me that, in part, what we are trying to achieve here, hopefully, without sacrificing the rights of the borrower, is more disciplined servicing of this loan portfolio. It seems to me that

there is an institutional need for someone who would be willing not only to buy the paper but to assume that servicing responsibility, which I think gets around to Mr. Clare's testimony.

And that would be, perhaps, a natural owner or servicer of this paper would be, perhaps, the commercial banking system, if in fact it had the latitude to do so. In other words, I could envision a commercial bank creating an investment fund that buys these securities and the bank is into a servicing contract on the securities held in the portfolio, if in fact the Glass-Steagall Act were modified to a degree to allow that.

There is probably some disagreement on whether that would be an appropriate course of action, but I really would like to hear your comments.

Mr. CLARE. Citibank is a very large servicer of all sorts of obligations, from mortgages to cars and everything else you can imagine. Whether or not we would be interested in aggressively bidding on the servicing, I just do not know. That is not an area of the bank with which I am terribly familiar. I suspect we would be very interested in seeking that business if it were separated from the actual holding of the security.

There may be other pockets of the bank that would also be interested in buying the securities, holding them, and servicing them. But I think it is probably unlikely.

Mr. COOKE. Mr. McMillan, I think, over time, the private markets or private servicers will step into the breach. I think it is a question of a transition period—as you sell these loans you should not try to transfer on day 1, all of the servicing to the private sector. Rather, the servicing transfer may be more successful if done gradually over a period of years.

I think Farmers Home is developing useful information on the servicing transfer issue. Farmers Home is conducting pilot programs in Puerto Rico and South Carolina, in which they have private servicers servicing their rural housing portfolios. They are undertaking this experiment as part of their pilot program to see what they have to do, in effect, to make that work.

But in the context of borrowers rights, as I said earlier, a private sector servicer has a real problem if he has to be expected to put in place some mechanism to deal with administrative appeals, moratoria, interest rate subsidies, and those sorts of things. But if you use flexibility and adequate transition, I think you will have a viable private market for servicing of Government assets.

Mr. MCMILLAN. I think a lot of your testimony has been sensitive to that point. I view what we are undertaking here as not making a decision about a short-term sale of Government assets to solve a short-term problem, but rather building toward creating an ongoing secondary market that is going to cause some institutional change to respond to it.

I guess what we are looking for from you, perhaps more than anything, is advice on how to design this and manage it. But also some assurance that that institutional secondary market is going to be there and be there consistently if the Government does the job of packaging and delivering to it, investment rate securities.

Mr. COOKE. I think it is fair to say it will be there if the Government works with Wall Street to develop that package of investment grade securities.

Mr. MCMILLAN. I think the level of your testimony and the quality of your testimony indicates that there is a strong interest in this on the part of the investment banking industry and possibly the commercial banking industry. Would that be a fair assessment?

Mr. COOKE. Yes.

Mr. BLUME. Yes.

Mr. MCMILLAN. Thank you.

Chairman LAFALCE. Mr. Hiler.

Mr. HILER. I thank the chairman.

Gentlemen, I frankly think that the asset sales is a very exciting idea whose time came a long time ago. I am glad to see that we are putting that idea into effect. It seems to me that where Government programs, at times, have failed is that the Government has tried to be the doer of the activity rather than the grease that allows everything else to come together. And, I think, in the small business area this is particularly true.

Small businesses have an incredibly difficult time gaining access to the debt markets at reasonable interest rates. It is one of the reasons why the SBA Guarantee Program is even in place, because so often small businesses just cannot go in and get money at a very good rate. The guarantee is necessary at times for that loan to be given.

It seems to me if we think of the Government as providing the grease that allows the small business sector to gain access to the secondary markets the way much larger firms already have access, that we will have more liquid markets, we will help small banks—I do not know if we will help Citicorp—but we can help a small bank in northern Indiana that maybe does not mind extending small business loans but maybe can only extend several. We help the small business, and when the small business is helped, employment increases and the overall economy is helped.

I think if we did not have the secondary mortgage markets today, we would not have nearly the kind of home ownership that we have. There is no reason why this cannot take place in the small business area as well.

But we do have one area of loans in the small business area that are given more as a reason to try to effect social change as opposed to being the greasing agent, as it were. And that is the direct loan area. Clearly, the direct loans that are given through the Small Business Administration are a lot higher risk and are given to the bottom end borrower from the standpoint that if you cannot get money from the commercial bank or other area, if you cannot get a guarantee, then you can qualify for a direct loan.

And given that, do you think that selling off the direct loan portfolios, do you think that we are going to get any kind of money at all for that direct loan portfolio?

Mr. BLUME. Let me try to answer that. I am assuming that you are going to sell these without recourse. And if, as you say, the people who these loans have been extended to are the types that could not obtain a 90-percent guaranteed loan, for example, then I think you are saying that these are poor credit risks.

And, not having reviewed the portfolio, I cannot make any judgments. But I would say that you are going to get less rather than more, and it would take some very artful structuring to generate any kind of reasonable proceeds.

Mr. HILER. Let me use the word "risky" credit as opposed to poor credit. Maybe for people without any proven track record or with a business plan that takes a lot of things going right, I would rather use the word "risky" than "poor". But there is a higher default rate in that area.

Mr. BLUME. What the investment community will look for, certainly, is what has the track record been of those loans. We will want to come to grips with prior default experience as a way, and perhaps the only way, to try to predict the future behavior of such loans, although it is, obviously, not an accurate predictor. But people will want to know what kind of experience the SBA has had with those loan portfolios before they could make a value judgment.

Mr. HILER. Just to make one other point with the question. We are told, and OMB said, that they would get us some amount of figures to either support what we are told or to detract from what we are told.

We are told that in the last 4 or 5 years that the Guarantee Loan Program and the Direct Loan Program has been tightened up a great deal; that the risk that is out there is not as high today as what it might be with loans that were extended either on a direct basis or on a guaranteed basis in the late 1970's.

When we go to sell these loans, when you folks go to underwrite them or to advise us on how to underwrite them, is it going to be the case that there is going to have to be loans made previous to a particular point in time are going—if we try to include those in the selling of the loans we are going to bring down the entire price that we would get for what might be better quality direct and guaranteed loans?

Mr. BLUME. I think we will look at a point in time not to see the credit standards in place at the time they were originated, but more so to see that they have been outstanding for a period of time and have been kept current.

If we looked at the time they were originated, it would be the older, the better, because it shows that they are seasoned and the borrower has a history of making payments, not so much that the credit standards were tightened in a given year.

Mr. HILER. I think the figures that OMB gave us last week were that there is something like $8 billion in portfolio there, of which $1.5 billion is considered to be over 1 year overdue in terms of payment.

Mr. CLARE. Those would be difficult to sell.

Mr. HILER. We will have fun, whoever is selected to do the advising on this, getting into all that.

Mr. Chairman, I yield back.

Mr. MCMILLAN. Would the gentleman yield for just one little followup question on that point? I believe it was you, Mr. Blume, that talked about the possibility of trying to find some middle ground somewhere between recourse and nonrecourse by the Government subordinating its interest.

Would you mind just elaborating on that just a little bit, because I think it is, maybe, an avenue that should be explored a little bit further or understood by the committee a little bit further.

Mr. BLUME. The concept can be simply described as follows: If you have a portfolio that has a current interest rate on it and an investor has been asked to buy it without recourse and you have told him that there will be no defaults on this portfolio, he may say to himself: "I do not believe you; I think the default rate is going to be 30 percent." And, in simple terms, he is going to pay you only 70 cents on the dollar for it.

If you are right and he is wrong, he has bought for $70 something that is worth $100. If you think you are right, perhaps you say to him:

> You give me $70 and I will give you the first $70 of cash-flow from this portfolio, but I will retain the next $30 of cash-flow from this portfolio if it does come in.
>
> If it does come in, I get to keep it and you do not. If it does not come in, you are no worse off than if you paid $70 for the portfolio.

Mr. MCMILLAN. By that you mean that the Government has not assumed any additional risk. It simply retained the risk it already had. Right?

Mr. BLUME. Right. The idea then would be that over a period of time if the same investor sees that the same piece does have some value, then perhaps the Government can sell it for $30 or $20 or something.

So, in essence, if you believe in the upside, you are holding it until the investor believes in the upside. That is a form of overcollateralization, or if you want to call it partial recourse. But it is a way of increasing proceeds.

Mr. MCMILLAN. In your experience then in dealing with the sale of Government securities, is that a feasible thing for us to consider?

Mr. BLUME. I think it should be considered, and I think in a couple of the programs it is being considered.

Chairman LAFALCE. Can it be considered under the present guidelines?

Mr. BLUME. Not the way they are written.

Chairman LAFALCE. It is being considered even though it violates the guidelines?

Mr. BLUME. Those guidelines are just guidelines. For example, with the Farmers Home Community Development Program, I think this idea of subordination is being considered. Second, with regard to servicing, I wanted to raise this earlier. The guidelines say that the servicing has to be sold or transferred to the purchaser. I think the intent there was that the servicing not be retained by the Government. I understand that there is no prohibition against third party servicing.

Mr. MCMILLAN. Thank you.

Chairman LAFALCE. Let us try to flesh out a few problems. First of all, the purposes of what the Reagan administration has in mind. You are the only witness, Mr. Moffitt, from the administration. In your prepared testimony you said, the objectives of loan asset sales are to reduce the Government's cost of administering credit by transferring servicing, collection, and other administrative activities to the private sector; to provide an incentive for

agencies to improve loan origination and documentation; to determine an actual subsidy of a Federal credit program; and to increase unified budget offsetting collections in the year of sale.

Let me just ask one question. What do you mean by that fourth item? Is that deficit reduction?

Mr. MOFFITT. Yes.

Chairman LAFALCE. Increased unified budget offsetting collections in the year of sale. OK, now we have it.

I do not know what the collective judgment of the Congress is. But as far as I am concerned, I do not think that we should be engaged in the sale of assets for the purpose of deficit reduction. It may be a benefit incidental to it. But I think it would be most unwise if that were one of our purposes because then you are using it for current consumption, and I do not think you should sell assets for current consumption. You can sell assets legitimately for other purposes.

Private sector, what is your judgment on my judgment? On that observation?

Mr. WARNER. A couple of observations. First of all, in terms of——

Chairman LAFALCE. It seems that everything you do is dependent on what your objectives are and how you structure something is dependent on what your objectives are. If we have an objective that just does not hold up to snuff, then we ought to forget about that objective and look at the other objectives and proceed accordingly.

Mr. WARNER. If I could make three points. First of all, in my testimony in terms of the Congress of course, I have been talking about mandated sales by Congress. The loan asset sales have been recommended by the administration. But also they have been mandated by Congress. So what we are talking about here is congressional action.

Chairman LAFALCE. Let me ask you this now. Can there be a sale of the assets if it is not mandated by Congress? Is there legal authority for the administration to sell off these assets without a congressional mandate? Does anybody have the answer to that?

Mr. WARNER. Perhaps in this case, of course, I should defer to SBA.

Chairman LAFALCE. Mr. Moffitt.

Mr. MOFFITT. Mr. Chairman, we have an opinion by our general counsel, Bob Weber, to the effect that yes; we do have the authority, that you have given us that authority.

Chairman LAFALCE. So you could do it anytime you wanted to?

Mr. MOFFITT. We believe that we could; yes.

Chairman LAFALCE. Is this just with respect to SBA or is this with respect to Government assets at large?

Mr. MOFFITT. I will just comment on what our general counsel said. He was dealing strictly with SBA.

Chairman LAFALCE. When you say that we had given you this authority, does this "we" mean through the medium of the Small Business Act and its amendments in some fashion or other?

Mr. MOFFITT. Yes.

Chairman LaFalce. Does legal counsel know whether other agencies have this through some other general legislation or not? Or you do not know?

Mr. Moffitt. General counsel did not comment on that.

Chairman LaFalce. OK. Please proceed.

Mr. Warner. To continue, as mentioned there is a $540 billion loan asset market out there. It is established. Lots of different corporate entities sell for lots of different reasons. We have enumerated some of those in our testimony.

For the U.S. Government to be selling loan assets, or indeed, physical assets here, is no different than the course of action already pursued by much of corporate America. And indeed, by much of the other industrialized states of the world.

Third, I think that it is clear that when programmed assets are to be sold versus those which will never be sold, there is an incentive to administer, manage, collect, and so on, in a way quite different than if these assets were never to be sold.

I know, for example, that a couple of years ago before loan sales became much talked about and later mandated, that agencies really had a very limited idea of what their default rates were, what their delinquency rates were. They had no idea, necessarily, of the state of documentation throughout the various offices. There was no incentive, absolutely no incentive.

So many of the skilled personnel and the agencies are very hard working people, obviously, talented people. And it comes to a list of priorities. And there was no priority whatsoever to see that documentation was satisfactory, that payments were kept up, that definitions which would never be used be clarified.

One key definition for example, I remember when Mr. Clare and I were——

Chairman LaFalce. Could you make your points a little more succinctly please, because you are still on your second point? And I think I understand and accept it.

Mr. Warner. The third point is enhanced management—great management advances through privatization achieved through loan sales.

Chairman LaFalce. I had asked a question as to whether the private sector concurred with my judgment that it was extremely important to determine whether one of the purposes should, in fact, be deficit reduction as opposed to other purposes. And that it would not make too much sense to have a sale of assets for the purposes of current consumption. Do other members of the panel have some thoughts on that?

Mr. Blume. Mr. Chairman, as I mentioned in my testimony, I think if you just look at the pilot program and not at the credit reform, I think loan asset sales only solve current deficit problems. But in the future at the same program level you are going to have an increased deficit. So, in effect, what you are doing when you sell a loan is you are selling future payments.

Chairman LaFalce. So you are saying it would not make too much sense for that purpose.

Mr. Blume. Yes; that is what I am saying.

Chairman LaFalce. Good. I just want to make sure.

Mr. Cooke.

Mr. COOKE. I would defer to Mr. Clare. I have tried to restrict my comments to those issues I feel most comfortable with, that we can answer concerning investor concerns on Wall Street. I think the chairman's question gets into the area of public policy.

Chairman LAFALCE. That is what we are concerned about.

Mr. COOKE. I know. But, I think, we on Wall Street are best capable of effectuating your policy once you have determined what the appropriate policy is.

Chairman LAFALCE. You are not refraining from answering that question because it might jeopardize a future possibility of underwriting?

Mr. COOKE. No; I appreciate the debate that is going on and I am watching it and monitoring it. I had suggested in my testimony as well as in my summary——

Chairman LAFALCE. In the back of my mind, too, is to what extent should I be relying upon your testimony? Because if you were strictly advisors to the Government, that is one thing. But since you are all potential underwriters you have a vested interest in having as large a pool of assets available for sale as is humanly possible. I think that is fair to say.

Mr. COOKE. Yes; But I think the discussion of whether it is on or off budget for scorekeeping purposes gets to a separate part of the overall policy argument.

Chairman LAFALCE. That is a totally separate question. We will get to that. Mr. Clare.

Mr. CLARE. I share some of Mr. Cooke's concerns that you are moving out of our range of expertise. But I would like to say that you are faced with a difficult challenge obviously. The Government needs more money. Does it get it by raising taxes, lowering spending, increased borrowing, selling assets? I, personally, would prefer to see reduced spending. But it seems like the will of the Congress, at this moment in time, is that the additional revenues should come from selling assets.

Chairman LAFALCE. The least painful way of arriving at a mandated goal. Yes, John.

Mr. HILER. Mr. Chairman, would you possibly yield so that I could put myself in that seat there and answer your question?

Chairman LAFALCE. Sure, John.

Mr. HILER. Just an observation. It seems to me that in terms of the selling of the loan, as to whether or not it makes sense in terms of selling off assets for current consumption, the key question is what is the loan for? Once the decision has been made to grant a loan, all that we do by selling the loan is to get the present value of that loan in the marketplace. If you were selling off Yosemite Park or an x amount of money to put that money into Social Security for current consumption, clearly you are selling assets to try to lower the deficit for current consumption.

But if you sell a loan in the marketplace that was granted to build a factory, then that consumption that you are using is actually an investment in the future. And it gets to the purpose of the loan more than it gets to whether the private sector holds it or the Government sector holds it.

Mr. MCMILLAN. Mr. Chairman, if we are going to pursue this question further with them, I would also like to hear them respond

to it not just in terms of sale of assets for current consumption. But the wisdom of the policy on the sale of the assets if the proviso were in effect that proceeds be used for debt retirement rather than current consumption, which I think may be a more supportable approach from my standpoint. I would be interested in their views to the extent that they want to express them on public policy.

Chairman LAFALCE. Surely much more acceptable from my perspective also.

Mr. MCMILLAN. One other point. I have not been in the business. I would just simply observe that I do not think these gentlemen are down here trying to encourage us to initiate a policy so that they can underwrite the sale of Government securities. Regardless of whether the Treasury issues the securities or whether we reduce spending and leave the money out there in the economy, these guys are going to figure out a way to get their hands on it one way or the other.

Mr. WARNER. Regardless of what the purposes are behind a sale of loan assets and regardless of how those loan proceeds are scored or used, in our judgment the sale of loan proceeds is going to significantly enhance proper comprehensive and business-like management of the programs. And we think that if that alone were the objective and the goal, that alone would justify serious consideration of loan asset programs.

But in point of fact, we all know it goes beyond that too.

Chairman LAFALCE. We may all know it but it is important to underscore that at times. The purpose of the Government programs is to achieve some socioeconomic purpose. Ostensibly, the judgment of the Congress could not have been achieved adequately by the private sector alone, which automatically means you are talking about a discount.

Mr. BLUME. Two points. First, I am not going to recommend that you sell loan assets or not sell loan assets. I think I can only do two things. One is to tell you the best way to do it from our perspective. And two, if you are trying to balance the budget merely by selling loan assets without doing anything else, that is not going to get you there, because in future years you are going to have a bigger hole.

Second, with respect to what any of the asset proceeds are used for, how they are scored on budget, I have no expertise on. But I do think to the extent that you get revenues for them, the Treasury borrowing that year will be reduced. And so, I think you will have that effect no matter what happens.

Chairman LAFALCE. Let me tell you why I am interested in pursuing that question. Because in my mind what is important is how it will be structured. But it is also important because if that is not the primary purpose, as Mr. Wright said 2 days ago, I am wondering if there are not other and better ways of accomplishing your other purposes. So let us take the other purposes as articulated by Mr. Moffitt.

Reduce the Government's cost of administering credit by transferring servicing, collection, and other administrative activities to the private sector. My first question is, cannot SBA at least—and I suspect other Government agencies too—but I will not ask you

that, presently transfer servicing, collection, and other administrative activities to the private sector?

Mr. MOFFITT. Yes; and we have done that to some degree, to a very minimum degree.

Chairman LAFALCE. You could do it to almost whatever degree you desired. Could you not?

Mr. MOFFITT. Yes; we are now using outside collection agencies.

Chairman LAFALCE. And you could use outside servicing agencies and other administrative activities. Could you not?

Mr. MOFFITT. Yes; we could.

Chairman LAFALCE. I just think it is relevant to know that.

Mr. MCMILLAN. Mr. Chairman.

Chairman LAFALCE. Yes.

Mr. MCMILLAN. Could I just raise one other point here that we may be overlooking. I do not think you can just view this question as one of sale of assets for current consumption, vis-a-vis, sale of assets with the proceeds used for retiring long-term debt because there is always a new outlay of funds for loan purposes, which if we create, successfully, this secondary market, might immediately find that secondary market and, therefore, be a significant reduction in current Government obligations. I think that is something we ought to try to quantify as we go through this process.

Chairman LAFALCE. That is true. But we also have to consider, for example, if somebody is going to obtain either a direct loan or a guaranteed loan from the Small Business Administration, it is with some expectation that they would be dealing with the Small Business Administration insofar as the servicing of that loan.

If the Small Business Administration sells off the direct loan, and transfers in toto, all servicing and administration of that loan, it would have not only an impact upon the present borrower, but also on potential borrowers. It would also seem to me to have a profound impact on the achievement of the socioeconomic purpose of the legislation.

Mr. MOFFITT. Mr. Chairman, if I could comment. We are, as you know, mostly out of the direct lending business. The vast majority of our loans are guaranteed.

Chairman LAFALCE. Except for minorities, handicapped, and servicemen.

Mr. MOFFITT. Which is a very small portion of the portfolio. And it is presumed that the loans that we make under the Guaranteed Loan Program, which is 98 or 99 percent of all of our loans, those loans will be serviced by the banks. I believe that the borrower, when he goes to a bank for an SBA guaranteed loan, recognizes, at least up to the point of failure, that he is going to be dealing with the bank as a servicing agent.

Chairman LAFALCE. What would you sell? Would you be selling the guarantee?

Mr. MOFFITT. No; obviously you cannot sell what you do not own. We would be selling the direct portion. The only part of the Guarantee Loan Program we would be selling would be those loans that we have repurchased.

Chairman LAFALCE. Let us talk about another question. My counsel came up and told me that there is another meeting that I have to go to that has just been called.

There are so many open questions here that clearly, if we are going to do this we ought to do it, as Mr. Wright said, on a pilot basis. And we say that we are doing it on a pilot basis. But my question is, are we really doing it on a pilot basis or are we just saying that? If we are to effectuate the proposals of the Reagan administration, Mr. Moffitt, how much of SBA's loan assets are we suggesting be sold?

Mr. MOFFITT. In the 2-year period it represents approximately one-third of the direct loan assets that we have had.

Chairman LAFALCE. Give that to me in dollar figures. How much as a percentage of the total?

Mr. MOFFITT. It is approximately the entire direct portfolio. It is slightly over $9 billion. We are proposing to sell $3 billion.

Chairman LAFALCE. $3 billion sounds to me a lot more than a pilot program. Especially when you are talking about loans that have gone to, in large part, minorities, the disadvantaged in the society, physically or socioeconomically, et cetera. I am just wondering if we were to embark on a sale of such SBA assets whether in the first year or first 2 years we should be talking about something in the magnitude of $3 billion.

It is my understanding that the $3 billion also represents almost 30 percent of the total amount of loan assets that would be sold by the Federal Government under the Reagan administration's proposal. So it is about a third of your assets. And it is also about a third of all the assets that are going to be sold by just one small agency, the SBA.

That is hardly pilot, it seems to me.

What do you think, Mr. Moffitt? And what do you gentlemen think?

Mr. MOFFITT. Mr. Chairman, we prefer not to characterize the sale, either as a pilot or otherwise.

Chairman LAFALCE. In other words, you agree with me but you cannot say it.

Mr. MOFFITT. I think we have the numbers mandated. And whether that constitutes a pilot or does not constitute a pilot, the numbers are there.

Chairman LAFALCE. If you are talking about loans of this nature that, traditionally, have had a very high default rate, at least relatively speaking, what would you gentlemen feel comfortable with if you were not forced to sell this by legislation and if you were advising SBA? Would you not want to test the market, gentlemen? And if you would test the market, what would you recommend? Be mindful, the total portfolio is $9 billion, roughly.

Mr. WARNER. Mr. Chairman, as I mentioned in my written and verbal testimony earlier, we see out there in terms of the Federal loan portfolios, generally, tens of billions of dollars of high quality loan assets which can be sold without recourse. We also see a number of weak loan portfolios.

We have established criteria for what constitutes a weak portfolio. If SBA's financial advisor comes back with an analysis of the portfolio which would characterize it as a weak portfolio in terms of default statistics, documentation, and historical contracted for or expected agency forbearance, then it would merely be our judgment that the loan portfolio would not receive an acceptably high

price in the marketplace because it could not be, by definition, adequately structured and investment grade rated on a nonrecourse basis.

At which point, again as we note in our testimony, we believe that the GAO report which calls for further study in terms of partial recourse, possibly for certain portfolios, merits serious consideration.

Chairman LAFALCE. Mr. Blume.

Mr. BLUME. Mr. Chairman, I assume we are talking about without recourse. Because with recourse, that is not a difficult sale at all. Without recourse, it is my understanding that SBA has a portfolio of x billion of direct loans and between now and the end of October it is contemplating raising approximately $250 to $300 million.

I do not know whether it can do that. We have not looked at their portfolio yet. I do not think that it is unreasonable to plan for that assuming your objective is not to sell the worst loans or a cross section of loan, but your objective is merely to raise $300 million in some form.

Chairman LAFALCE. That is why it is so important to determine what your principal objectives are. Should we have a principal objective that we have to raise $250 or $300 million? Or let us talk about credit reform management techniques, as Mr. Wright says, and then incidentally, whatever we make from that we can apply either to deficit reduction or deficit retirement. Because you proceed very differently.

And if you are talking about pilot, if you establish that you have to make so much money up front you forget about the pilot concept. You sell whatever is necessary in the marketplace to raise that dollar amount. The problem is we are proceeding with a lack of intellectual honesty and integrity. If we had this intellectual honesty and integrity as to what we really want to accomplish, I think we would be proceeding very differently.

I am, unfortunately, being called elsewhere. Do any other members have questions they would like to ask at this time?

Mr. HAYES. I can think of only one which is very brief. There was an effort, and we thought we had forestalled it in the past 2 years, to eliminate the Small Business Administration. We thought we would breathe new life into it.

Do you see this sale of the assets or the guaranteed loan as proposed by the administration as part of the process of reaching that objective? Because there is another way to do it, you know. You have $9 billion worth of loans. I am asking you, Mr. Moffitt.

Mr. MOFFITT. Congressman, no; I do not.

Mr. HAYES. You do not see that as a way of——

Mr. MOFFITT. Backdooring or accomplishing what could not be done in that regard for the last 2 years. No; I definitely do not see that.

Mr. HAYES. I would hope not. I will be around, hopefully, to see.

Mr. MCMILLAN. Mr. Chairman, just one comment. I would be glad to join you in approaching the problem with intellectual honesty. I look forward to that.

Chairman LAFALCE. Thank you very much, gentlemen. The committee stands adjourned.

[Whereupon, at 11:50 a.m., the committee adjourned, subject to the call of the Chair.]

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